Supreme Court, U.S.
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No. 94_____

IN THE
Supreme Court of the United States
October Term, 1994

UNITED STATES LINES, INC. &
UNITED STATES LINES (S.A.) INC.
REORGANIZATION TRUST, as Successor-in-Interest
to UNITED STATES LINES (S.A.), INC.,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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October 25, 1994

QUESTION PRESENTED

Whether the two-year statute of limitations relating to the commencement of avoidance actions contained in section 546(a)(1) of the Bankruptcy Code prior to its recent amendment applies not only to trustees appointed under certain provisions of the Code specified in the section but also to debtors-in-possession who are not mentioned in the section?

LIST OF PARTIES AND RULE 29.1 LIST

The parties to the proceedings below were the petitioner, United States Lines, Inc. & United States Lines (S.A.) Inc. Reorganization Trust ("USL Reorganization Trust"), as successor-in-interest to United States Lines (S.A.), Inc., and the respondent, the United States of America on behalf of the Maritime Administration. Chemical Bank, solely in its capacity as depository, was a party to the proceeding before the Bankruptcy Court but did not participate in the proceeding before the District Court or the Court of Appeals. Pursuant to the terms of Debtors' First Restated Joint Plan of Reorganization, all of the assets of United States Lines (S.A.), Inc., including any and all causes of action, were assigned to the USL Reorganization Trust, as successor-in-interest.

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to UNITED STATES LINES (S.A.), INC.,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

United States Lines (S.A.), Inc. respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in the above-entitled proceeding on July 28, 1994.

OPINIONS BELOW

On September 11, 1991, the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") granted the motion of United States Lines (S.A.), Inc. ("USL") for summary judgment in the adversary proceeding initiated by USL against the United States of America on behalf of the Maritime Administration ("MARAD") under sections 547(b), 550 and 502(d) of the Bankruptcy Code to avoid and recover certain preferential transfers and denied MARAD's cross-motion for summary judgment. The Bankruptcy Court's opinion, as corrected on September 17, 1991, is reported at 132 B.R. 247 and is reprinted at A46 - A84;[1/] its order dated October 4, 1991 is reprinted at A85 - A88. The United States District Court for the Southern District of New York (the "District Court") affirmed the Bankruptcy Court's order by opinion dated December 17, 1993, as amended on December 22, 1993. The District Court's amended opinion is reported at 162 B.R. 410 and is reprinted at A13 - A43; its judgment dated December 29, 1993 is reprinted at A44 - A45. On July 28, 1994, the United States Court of Appeals for the Second Circuit (the "Court of Appeals" or "Court below") reversed the District Court's judgment pursuant to an opinion dated July 28, 1994. The Court of Appeals' opinion is reported at 30 F.3d 385 and is reprinted at A1 - A8; its judgment entered on July 28, 1994 is reprinted at A9 - A12.

[1/] Citations to "A__ to A__" are to pages of the accompanying Appendix of petitioner.

JURISDICTION

This proceeding arises under the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101 to 1330) (1994) (the "Bankruptcy Code" or "Code").[2/] The judgment of the Court of Appeals was entered on July 28, 1994. A9 - A12. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

The principal statutory provision involved herein is section 546(a) of the Bankruptcy Code, which provides:

> An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of:
>
> (1) two years after the appointment of a trustee under section 702, 1104, 1163, 1302, or 1202 of this title; or
>
> (2) the time the case is closed or dismissed.

11 U.S.C. § 546(a) (1994).

[2/] Unless otherwise indicated, all statutory references in this petition are to the Bankruptcy Code prior to the enactment of the Bankruptcy Reform Act of 1994.

STATEMENT OF THE CASE

I. Basis for Federal Jurisdiction

The jurisdiction of the Bankruptcy Court was invoked under 28 U.S.C. §§ 1334 and 157(b). The jurisdictional basis for the appeal of the Bankruptcy Court's order to the District Court was provided by 28 U.S.C. § 158(a). The jurisdiction of the Court of Appeals was invoked under 28 U.S.C. § 158(d).

II. Statement of the Facts

This case concerns the ability of USL to pursue its action under section 547(b) of the Bankruptcy Code to avoid an assignment of charter hire (now over $10 million) made to MARAD by USL just prior to its bankruptcy filing in November 1986. At issue is the question of whether the preference action against MARAD is time-barred by operation of the two-year statute of limitations contained in section 546(a)(1) of the Bankruptcy Code which, by its plain language, is applicable only to appointed trustees.

Prior to its chapter 11 filing, USL, together with its affiliate, United States Lines, Inc.,[2] operated the largest United States flag shipping business and was one of the largest cargo carriers in the world. During the mid-1980's, however, USL suffered serious operating losses. As part of a restructuring plan to increase revenues, USL agreed in 1986 to bareboat charter three of its vessels (the "Vessels"). A49 - A50.

The Vessels were built and later modified with financing provided in large part by United States government programs administered by MARAD. A47 - A48. Two series of bonds in the

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[2] United States Lines, Inc., its parent, McLean Industries, Inc. ("McLean"), USL and its affiliate, First Colony Farms, Inc., are collectively referred to herein as the "Debtors."

aggregate principal amount of $45,826,000 were issued by USL's predecessor in interest, Moore-McCormick Lines, Inc. ("Moore"), and were guaranteed under title XI of the Merchant Marine Act, 1936, as amended, 46 U.S.C. §§ 1271 *et seq.* (the "Title XI Guarantee"). *Id.* Moore's obligations to MARAD under the Title XI Guarantee were secured by first and second priority preferred ship mortgages on the vessels in favor of MARAD (the "MARAD Mortgages").[4] *Id.*

On September 24, 1986, USL and Lykes Brothers Steamship Company ("Lykes") entered into a formal agreement that provided for a three-year bareboat charter of the Vessels and granted Lykes an option to purchase the Vessels. Under the terms of the MARAD Mortgages, however, USL was prohibited from bareboat chartering the Vessels without MARAD's consent. A49. MARAD agreed to waive that covenant on the condition that USL grant MARAD a security interest in the charters and the charter hire. A50. On November 4, 1986, USL and Lykes entered into three bareboat charters and USL, Lykes and MARAD entered into a Charter Assignment and Agreement pursuant to which USL granted MARAD a first priority security interest in all payments made by Lykes to USL to charter the Vessels.[5] *Id.*

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[4] In early 1983, with $50 million of acquisition financing provided by Chemical Bank, McLean purchased Moore and renamed it USL. A48 - A49. As collateral for its loan, Chemical Bank was granted a third priority preferred ship mortgage on the Vessels. A49.

[5] On that date, MARAD and Chemical Bank also entered into a Depository Agreement pursuant to which Chemical Bank agreed to receive the charter hire and to transfer it to USL provided MARAD had made no demand for the charter hire under the Title XI Guarantee; and MARAD and Lykes entered into an agreement pursuant to which Lykes acknowledged the MARAD Mortgages and MARAD's interests in the charter hire, including MARAD's rights as a mortgagee to foreclose upon the Vessels and the charter hire. A50 - A52.

On November 24, 1986, less than three weeks after executing the assignment documents which granted the challenged security interest to MARAD, the Debtors filed for protection under chapter 11 of the Bankruptcy Code. A52. USL continued to operate its business as a debtor-in-possession in accordance with section 1107 of the Code. A52 - A53. No trustee was ever appointed in any of the Debtors' chapter 11 cases.

For the next two and a half years, management of USL focused on the task of negotiating with its creditors and formulating a consensual chapter 11 plan that contemplated the emergence of USL as a viable going concern. However, due to poor shipping industry conditions, USL was ultimately forced to terminate its operations, abandon its reorganization effort and quickly design a plan for the orderly liquidation of its shipping assets.

On March 23, 1989, the Bankruptcy Court approved the Debtors' Second Amended and Restated Disclosure Statement (the "Disclosure Statement") and on May 16, 1989, the Bankruptcy Court entered its order confirming Debtors' First Restated Joint Plan of Reorganization (the "Plan") and establishing certain postconfirmation procedures, including appointment of a representative of the USL Reorganization Trust to pursue avoidance claims. USL did not perform a preference analysis prior to confirmation of its Plan.[6] A55. USL expressly stated in its

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[6] At the time of confirmation of USL's Plan, the prevailing view of the courts had been that the two-year statute of limitations in section 546(a)(1) did not apply to debtors-in-possession such as USL. *See Korvettes, Inc.* v. *Sanyo Elec., Inc.*, (*In re Korvettes, Inc.*), 67 B.R. 730, 733 (S.D.N.Y. 1986); *Perlstein* v. *Saltzstein* (*In re AOV Indus., Inc.*), 62 B.R. 968, 974 (Bankr. D.D.C. 1986); *Alithochrome Corp.* v. *East Coast Finishing Sales Corp.* (*In re Alithochrome Corp.*), 53 B.R. 906, 908-09 (Bankr. S.D.N.Y. 1986), *Boatman* v. *E.J. Davis Co.* (*In re Choice Vend, Inc.*), 49 B.R. 719, 720 (Bankr. D. Conn. 1985). Although, subsequently, (continued...)

Disclosure Statement that it reserved the right to pursue any preference claims after confirmation, and that such claims would become the property of the USL Reorganization Trust. A83 - A84. The Plan provided that, in addition to stock in the reorganized entity, unsecured creditors would receive the proceeds of any preferences recovered by the USL Reorganization Trust. MARAD did not object to any aspect of the Disclosure Statement or the Plan. A55.

In August 1989, USL advised MARAD that it intended to seek to avoid the pre-bankruptcy grant to MARAD of the security interest in charter hire as a preferential transfer and/or fraudulent conveyance.[7] A55.

III. Proceedings Below

In April 1990, USL commenced an adversary proceeding in the Bankruptcy Court seeking to set aside the assignment of the charter hire to MARAD as a preference under section 547(b) of the Bankruptcy Code. MARAD responded by raising various procedural and substantive defenses to the preference claim and arguing that USL should be equitably estopped from bringing the proceeding so late in the bankruptcy case. *See* A56 to A82.

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[6](...continued)
on December 10, 1990, a circuit court (the Tenth Circuit) ruled to the contrary for the first time in *Zilkha Energy Co.* v. *Leighton*, 920 F.2d 1520, 1524 (10th Cir. 1990), courts in the Second Circuit, prior to the recent decision in *United States Brass & Copper Co.* v. *Caplan* (*In re Century Brass Prods.*), 22 F.3d 37, 40 (2d Cir. 1994), uniformly rejected the *Zilkha* holding. *See, e.g., Bonwit Teller, Inc.* v. *Jewelmasters, Inc.* (*In re Hooker Invs., Inc.*), 162 B.R. 426 (Bankr. S.D.N.Y. 1993).

[7] As of February 28, 1994, Chemical Bank had $11,415,117.42 on deposit in respect of the charter hire.

MARAD never asserted that the preference claim was untimely under section 546(a)(1) of the Bankruptcy Code.

On September 11, 1991, the Bankruptcy Court granted USL's motion for summary judgment and denied MARAD's cross-motion for summary judgment. *Id.* On the equitable estoppel issue raised by MARAD, the Bankruptcy Court ruled as a matter of fact that USL had specifically reserved the right to pursue preference actions in the Disclosure Statement and that "MARAD was not an innocent party duped into foregoing any of its rights." A84. Although the applicability of section 546(a)(1) was not raised as an issue by MARAD, the Bankruptcy Court, in the course of its decision, ruled that, based on the prevailing view of the courts in the Second Circuit at the time, under section 546(a)(2), USL had until the dismissal or close of the bankruptcy case to commence its adversary proceeding. A59.

On October 11, 1991, MARAD appealed the Bankruptcy Court's decision to the District Court and obtained a stay pending the District Court's disposition of the appeal. Again, although MARAD appealed many aspects of the Bankruptcy Court's decision, MARAD was silent before the District Court on the issue of the timeliness of USL's preference claim under section 546(a)(1) of the Code. A5, A19 - A20. More than two years later, on December 17, 1993, the District Court affirmed the decision below, agreeing with the Bankruptcy Court's findings that the various preference defenses raised by MARAD were unsupported by the factual record and erroneous as a matter of law. A21 - A43.

On February 24, 1994, MARAD filed its notice of appeal of the District Court's decision with the Court of Appeals. After MARAD had submitted its opening brief, the Court of Appeals, on April 13, 1994, rendered its decision in the *Century Brass* case, holding for the first time that the two-year statute of limitations contained in section 546(a)(1) applied to debtors-in-possession. A5. On April 28, 1994, under Rule 28(j) of the Federal Rules of Appellate Procedure, MARAD advised the Court of Appeals by letter of the recent decision in *Century Brass*. A6. This was the

first time that MARAD raised the argument that USL's preference claim was time-barred under section 546(a)(1)—four years after USL's adversary proceeding had been commenced, and at the second level of appellate review.

On July 28, 1994, the Court of Appeals reversed the decision of the District Court and ruled that, on the authority of *Century Brass*, USL's $11 million preference claim against MARAD was time-barred. A7. The Court of Appeals found that MARAD had preserved the section 546(a)(1) defense despite its failure to make the argument before *any* court prior to its post-brief letter to the Court of Appeals. A6 - A7.

REASONS FOR GRANTING THE PETITION

In *United States* v. *Ron Pair Enterprises*, 489 U.S. 235 (1989), this Court unequivocally stated that "[t]he task of resolving the dispute over the meaning of a [statutory provision] begins where all such inquiries must begin: with the language of the statute itself." 489 U.S. at 241 (citing *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 685 (1985)). "As long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain meaning of the statute." 489 U.S. at 240-41.

Section 546(a) of the Bankruptcy Code requires that avoidance actions must be brought within the earlier of: "(1) two years after the appointment of a trustee"; or "(2) the time the case is closed or dismissed." 11 U.S.C. § 546(a) (1994). The language of section 546(a)(1) is not vague or confusing; it refers only to trustees appointed under specified sections of the Code and does not mention debtors-in-possession. The provision does not expressly or implicitly incorporate, or contradict, any other Bankruptcy Code provision. There is no need to turn to the legislative history or pre-Code caselaw to understand what section 546(a)(1) really means.

Despite the clear and unambiguous statutory language, the Court of Appeals for the Second Circuit, together with courts of appeals in three other circuits, has insisted that section 1107(a) of the Bankruptcy Code[9] be engrafted upon section 546(a)(1) in order to subject debtors-in-possessions to the two-year limitation period that Congress expressly made applicable only to trustees. *United States Brass & Copper Co.* v. *Caplan (In re Century Brass Prods.)*, 22 F.3d 37, 40 (2d Cir. 1994) ("*Century Brass*"); *Construction Management Servs., Inc.* v. *Manufacturers Hanover Trust Co. (In re Coastal Group, Inc.)*, 13 F.3d 81, 84 (3d Cir. 1994) ("*Coastal Group*"); *Upgrade Corp.* v. *Government Technology Servs., Inc. (In re Softwaire Centre Int'l, Inc.)*, 994 F.2d 682, 684 (9th Cir. 1993) ("*Softwaire*"); *Zilkha Energy Co.* v. *Leighton*, 920 F.2d 1520, 1524 (10th Cir. 1990) ("*Zilkha*"). In direct conflict with these courts of appeal, the Court of Appeals for the Fourth Circuit, relying upon the "plain meaning" rule of statutory construction described by this Court in *Caminetti* v. *United States*, 242 U.S. 470, 485 (1917) and *Ron Pair Enterprises*, 489 U.S. at 240–41, ruled that section 546(a)(1), by its terms, applies only to trustees and not to debtors-in-possession. *Maurice*

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[9] Section 1107(a) provides, in pertinent part:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter.

11 U.S.C. § 1107(a) (1994).

Sporting Goods, Inc. v. *Maxway Corp.* (*In re Maxway Corp.*), 27 F.3d 980, 984–85 (4th Cir. 1994) ("*Maxway*").[9/]

On October 22, 1994, the President signed the Bankruptcy Reform Act of 1994 (the "1994 Act"), which amends various provisions of the Bankruptcy Code, including section 546(a)(1).[10/] However, no doubt recognizing that many of the amendments contained in the 1994 Act, including section 217, implement changes to prior law, Congress specifically provided that the 1994 Act only applies prospectively.[11/] Therefore, courts presiding over

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[9/] On October 6, 1994, Maurice Sporting Goods, Inc., the unsuccessful creditor-appellant in the *Maxway* case, 27 F.2d 980, in which the Fourth Circuit ruled contrary to the Court below, filed its Petition for Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit, also requesting this Court to resolve the question of whether section 546(a)(1) applies to a debtor-in-possession.

[10/] Section 217 of the 1994 Act amends section 546(a) of the Code to read as follows:

> An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the later of:
>
> (1) 2 years after the entry of the order for relief; or
>
> (2) 1 year after the appointment or election of the first trustee under Section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (1).

[11/] Section 702(b)(1) of the 1994 Act provides that, with certain exceptions not relevant here, the amendments to the Bankruptcy Code made by the 1994 Act apply only to bankruptcy cases commenced on or after the date of the enactment of the Act.

more than a million pending bankruptcy cases across the country that were commenced prior to the date of the enactment of the 1994 Act will still be required to construe and apply the Bankruptcy Code as written prior to the 1994 Act.[12] For that reason, the controversy over the interpretation of section 546(a)(1) continues to be a live one, with enormous economic consequences for over a million debtors and their creditors.

The conflict among the circuits over the interpretation of the pre-amendment version of section 546(a)(1) is irreconcilable. Moreover, in circuits where no court of appeals has ruled on the issue, divergent decisions at the bankruptcy court and district court levels as to the application of the section to debtors-in-possession are proliferating, thus contributing to greater confusion and uncertainty.[13] Finally, whether these valuable avoidance claims are time-barred if they are not asserted by a debtor-in-possession within two years from the date of its bankruptcy filing is an important question of federal law. While Congress may have paved the way for a more uniform application of the statute of limitations rule in future bankruptcy cases, only this Court can end the conundrum faced by courts wrestling with the pre-1994 Act version of section 546(a)(1).

I. The Decision of the Court Below Conflicts With the Decision of the Fourth Circuit and Adds to the Conflict Among the Circuits

On the authority of its own recent decision in *Century Brass*, the Court below reversed the District Court and Bankruptcy Court decisions and dismissed USL's preference claim against MARAD as time-barred under section 546(a)(1). *See In re Mclean*

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[12] As of June 30, 1994, 1,134,036 bankruptcy cases were pending, according to the Administrative Office of the United States Courts Statistics Division in Washington, D.C.

[13] See *infra* note 17 and accompanying text.

Indus., Inc., 30 F.3d at 387-88. Rejecting previously controlling authority in the circuit, the court in *Century Brass* opined that:

> [I]n light of the statutory scheme as a whole, § 546(a) applies to preference-avoidance actions brought by DIPs as well as to those brought by trustees. . . . Though [section 546(a)(1)] itself does not mention DIPs, that omission cannot be dispositive, for neither does § 547 itself permit a DIP to bring a preference-avoidance action.

Century Brass, 22 F.3d at 39 (citations omitted). Disregarding the plain language, the court reasoned that another provision of the Code, section 1107(a), authorizes a debtor-in-possession to bring a preference avoidance action, and that such authorization to act is "[s]ubject to any limitations on a trustee," including the statute of limitations applicable to a trustee. *Id.* The court also "found no indication in the legislative history that Congress, contrary to its precise language, intended DIPs not to be bound by the statutes of limitations restricting actions by trustees". *Id.* at 40.

Although the issue addressed in April 1994 by the Court of Appeals in *Century Brass* was one of first impression in the Second Circuit, courts of appeals in four other circuits have grappled with the question whether the two-year statute of limitations period contained in section 546(a)(1) applies to a debtor-in-possession. The Tenth Circuit was the first court of appeals to rule on the issue. In *Zilkha*, 920 F.2d 1520, the court made an interpretative leap to find that section 546(a)(1) was ambiguous and opined that the statute must be construed. *Id.* at 1524. Looking to section 1107(a) of the Code, the court concluded that Congress did not intend to limit the actions of a trustee without applying the same restriction to a debtor-in-possession. "Because of the virtual identity of function between a trustee and a debtor-in-possession," the court stated, "there would be no reason to create a different limitation period for the filing of actions by the two fiduciaries." *Id.*

A few years later, in the *Softwaire* case, 994 F.2d 682, the Court of Appeals for the Ninth Circuit agreed with the *Zilkha* court that the two-year statute of limitations set forth in section 546(a)(1) was intended to apply to debtors-in-possession as well as trustees. The *Softwaire* court ruled that section 546(a)(1) must be read in conjunction with section 1107(a), rejecting the "plain meaning" interpretation of the statute followed by many of the lower courts, and, instead, purportedly relying upon this Court's decision in *Kelly* v. *Robinson*, 479 U.S. 36, 43 (1986) ("[i]n expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and its object and policy.").[14/]

In January 1994, the Court of Appeals for the Third Circuit in *Coastal Group*, 13 F.3d 81, also ruled that the statute of limitations period set forth in section 546(a)(1) applied to both trustees and debtors-in-possession. Like the Ninth Circuit, the court opted to follow this Court's "statute as a whole" rule applied in *Zilkha* rather than this Court's "plain meaning" approach followed by most of the lower courts confronted with the issue.

Approximately one month before the Court below rendered its opinion in July 1994, the Court of Appeals for the Fourth Circuit in *Maxway*, 27 F.3d 980, affirmed the interpretation of each

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[14/] Notwithstanding the *Softwaire* decision, a conflict still exists within the Ninth Circuit as to whether section 546(a)(1) applies to debtors-in-possession. In *In re San Joaquin Roast Beef*, 7 F.3d 1413, 1414-15 (9th Cir. 1993), decided after *Softwaire*, the court held that the two-year statute of limitations commenced upon the appointment of the first trustee, even though a debtor-in-possession had been in place for approximately ten months prior to the chapter 11 trustee's appointment. Here, because the issue was not before it, given the procedural history below, the Second Circuit did not consider whether the appointment of the USL Reorganization Trustee under the Plan gave USL additional time to commence its avoidance action against MARAD.

of the lower courts that the two-year statute of limitations contained in section 546(a)(1) did not apply to debtors-in-possession. Directly conflicting with the decisions of the other circuits that had ruled on the issue, the Fourth Circuit opined that the language of the statute was clear on its face and that an application of the plain meaning of section 546(a)(1) was not inconsistent with the general statutory scheme of "functional equivalency" between a debtor-in-possession and a trustee established by the language and legislative history of section 1107(a) of the Code:

> In sum, we recognize that the question presented is difficult and that legitimate policy arguments exist on both sides. However, the language of § 546(a)(1) is plain; it provides that the two-year statute of limitations for bringing an avoidance action does not begin to run until the appointment of one of the trustees specified in § 546(a)(1). Application of the plain language of § 546(a)(1) in Chapter 11 cases would not produce an absurd result, nor is it inconsistent with the language of or contrary to the legislative history of § 1107(a).

Maxway, 27 F.3d at 984. The Fourth Circuit then applied the "plain meaning" rule by analyzing section 546(a)(2) consistently with section 546(a)(1), as discussed below, to distinguish the applicable limitations periods for appointed trustees and debtors-in-possession.

A. The Circuits Disagree Over the Application of the "Plain Meaning" Rule Laid Down by This Court

At the heart of the controversy among the aforementioned five circuits is one threshold question: Is the language of section 546(a)(1) ambiguous? If, as the Fourth Circuit in *Maxway* held, the language of section 546(a)(1) is clear on its face and consistent with the remainder of the Bankruptcy Code, then there "is no need for a court to inquire beyond the plain language of the

statute." *Ron Pair Enters.*, 489 U.S. at 240–41. Furthermore, "[o]ne must . . . listen attentively to what [a statutory text] does not say." *Connecticut Nat'l Bank* v. *Germain*, 112 S. Ct. 1146, 1150 n.2 (1992) (Stevens, J., concurring) (quoting Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Colum. L. Rev. 527, 536 (1947)). The fact that Congress omitted debtors-in-possession from the list of parties bound by the two-year period under section 546(a)(1) may, therefore, only be interpreted one way: a debtor-in-possession has until the dismissal or close of its chapter 11 case to act under section 546(a)(2), and no other period was intended to apply. As this Court stated in the *Germain* case:

> [C]anons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one, cardinal canon before all others. We have stated time and time again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there.

Id. at 1149.

Except for the Fourth Circuit, all of the other circuits that have ruled on the issue have presumed that Congress did *not* mean what it said in section 546(a)(1). Rather, these courts have inferred that, because section 546(a)(1) refers only to a "trustee" and because section 1107(a) gives a debtor-in-possession all of the powers of, and subjects it to all of the limitations imposed upon, a trustee, section 546(a)(1) must be read to include a debtor-in-possession. *See Century Brass*, 22 F.3d at 39–40; *Coastal Group*, 13 F.3d at 84–85; *Softwaire*, 994 F.2d at 683–84; *Zilkha*, 920 F.2d at 1524. In square opposition to the Fourth Circuit, these courts have found—more accurately, created—a so-called "ambiguity" in section 546(a)(1) in order to justify incorporating section 1107(a) under the "statute as a whole" principle of statutory interpretation enunciated by this Court in *Kelly* v. *Robinson*, 479 U.S. at 43.

The decision of the Court below, based on the rule in *Century Brass*, directly conflicts with the decision of the Fourth Circuit and disregards a fundamental tenet of statutory interpretation laid down by this Court: "The plain meaning of the legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" *Ron Pair Enters.*, 489 U.S. at 242. Only in cases "where the statutory language is open to interpretation" and, under the proposed interpretation, is in "clear conflict with state and federal laws of great importance" should the court look to legislative history and pre-Code practice to reach the proper interpretation. *Id.* at 245.

Recent decisions of this Court are replete with examples of this Court's adherence to the "plain meaning" rule when interpreting provisions of the Bankruptcy Code. For example, in *Toibb* v. *Radloff*, 501 U.S. 157 (1991), this Court determined that the language of section 109(d) of the Code[15] was clear and that "although a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity, there [was] no need to do so." *Id.* at 162. At issue in *Toibb* was the question of whether under section 109(d) a debtor not engaged in business could seek relief under chapter 11 of the Bankruptcy Code. This Court decided that section 109(d) did not expressly exclude non-business individual debtors from being eligible to reorganize under chapter 11 and since "the Code contain[ed] no 'ongoing business' requirement for Chapter 11 reorganization . . . [the Court found] no basis for imposing one." *Id.* at 166. Moreover, the scant legislative history on the issue "does not suggest a 'clearly

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[15] Section 109(d) defines who may be a debtor under chapter 11:

> Only a person that may be a debtor under chapter 7 of this title, except a stockbroker or a commodity broker, and a railroad may be a debtor under chapter 11 of this title.

11 U.S.C. § 109(d) (1994).

expressed, legislative inten[t] . . . contrary . . . to the plain language of section 109(d).'" *Id.* at 162. *See also Union Bank* v. *Wolas*, 112 S. Ct. 527 (1991) (the preference exception contained in section 547(c)(2) of the Code for payments made in the "ordinary course of business" did not implicitly exclude payments made on long-term debt).

B. The "Plain Meaning" of Section 546(a)(1) Is Consistent with Other Provisions of the Bankruptcy Code and the Legislative History

Like the bankruptcy provisions at issue in *Toibb* and *Union Bank*, the plain words of section 546(a)(1) are not open to interpretation. However, assuming that the provision was unclear, the Fourth Circuit's reading of section 546(a)(1) is still the only appropriate one. Based upon the rule in *Kelly* v. *Robinson*, 479 U.S. at 43, such a reading does not contradict any other provision of the Bankruptcy Code, the legislative history, or pre-Code practice. As one bankruptcy court correctly observed:

> Section 546(a)(1) does not say simply that its two year limitation applies to a trustee. Rather, the section provides that an action may not be commenced later than "two years after the *appointment* of a trustee under section . . . 1104 . . . of this title . . . ." This wording stands in sharp contrast to that used throughout the majority of the other sections of the Bankruptcy Code, which when they mention a trustee, do not talk about a trustee *appointed* under enumerated sections of the Code.

In re Hooker Investments, Inc., 162 B.R. at 435 (emphasis added). That court correctly observed that many other sections of the Bankruptcy Code —*e.g.*, sections 108(a), 324, 325, 330, 501(c), 521(3), 544, 545, 546(b) and (c), 547, 548, 550—refer only to a "trustee," not a trustee "appoint[ed]" under specific provisions of the Code, as does section 546(a). *Id.* Contrary to the implication in

the decisions of the Second, Third, Ninth and Tenth Circuits, not every reference to a "trustee" in the Bankruptcy Code incorporates the "debtor" as well (*see*, *e.g.*, sections 1103(c)(4), 1104, 1105), and the Code contains sections that expressly refer to "trustee" *and* "debtor" when it is intended that the provisions in question apply to both. *E.g.*, sections 366(a), 1103(c)(1), 1109(b).

The notion that trustees appointed under sections 702, 1104, 1163, 1302 or 1202 of the Bankruptcy Code—the provisions specified in section 546(a)(1)—are bound by a statute of limitations period that is not binding upon debtors-in-possession is not inconsistent with other provisions of the Bankruptcy Code that make express distinctions between trustees and debtors-in-possession. For example, section 365(d)(1) of the Bankruptcy Code gives a chapter 7 trustee only 60 days from the order for relief to assume or reject an executory contract, while under section 365(d)(2), a debtor-in-possession has until plan confirmation to make such a decision, unless a creditor obtains an order compelling the debtor-in-possession to decide sooner. As this Court observed, "[i]t seems to us that this difference between the two different types of proceedings reflects the considered judgment of Congress that a debtor-in-possession seeking to reorganize should be granted more latitude in deciding whether to reject a contract than should a trustee in liquidation." *NLRB* v. *Bildisco & Bildisco*, 465 U.S. 513, 529 (1984). A similar distinction can be drawn between a debtor-in-possession and a trustee with respect to the decision to commence an avoidance action.

Under section 1106(a)(3) and (4) of the Code, a trustee is required to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor" and "*as soon as practicable* file a statement of any investigation conducted . . . including any fact ascertained pertaining to . . . a cause of action available to the estate." (Emphasis added.) Under section 1107(a), however, a debtor-in-possession is expressly relieved of these duties, demonstrating that Congress designed the Code so that a trustee would act quickly to realize estate assets such as preference claims, while a debtor-in-possession would devote most of its time and

energy to resolving its business problems and negotiating with (not suing) its creditors. *See Stuart* v. *Pingree* (*In re AFCO Devel. Corp.*), 65 B.R. 781, 786–87 (Bankr. D. Utah 1986).

Nor does the legislative history suggest that the conclusion reached by the Second, Third, Ninth and Tenth Circuits was intended by Congress. First, the Senate Report from 1978 is not helpful because it conflicts with the actual language of the statute as it was enacted.[16] Second, a review of the bankruptcy laws in force prior to the enactment of section 546(a)(1) as part of the Bankruptcy Reform Act of 1978 shows that Congress never intended the two-year statute of limitations to apply to debtors-in-possession. As commentators have explained:

> The legislative history begins not with section 546 of the Bankruptcy Reform Act of 1978, but with section 77B, the corporate reorganization statute enacted in 1934. Section 77B(b)(10) provided for the tolling of all periods of time prescribed by the Bankruptcy Act and of all other statutes of limitations during the pendency of the reorganization . . . .
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> * * *
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> [The Chandler Act Amendments of 1938] gave liquidating trustees two years within which to initiate preference or fraudulent conveyance actions. However, this period was tolled during the pendency of a reorganization case. This was true even though the trustee or debtor-in-possession

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[16] The relevant passage states that "the limitation is two years after [the trustee's] appointment, or the time the case is closed or dismissed, whichever occurs *later*." *In re Hooker Investments, Inc.*, 162 B.R. at 436 (quoting S. Rep. No. 989, 95th Cong., 2d Sess. 87 (1978), 1978 U.S.C.C.A.N., 5787, 5873).

> had the power under Chapter X, XI, and XII to initiate preference and fraudulent conveyance actions . . . .

Gerald K. Smith & Frank R. Kennedy, *Fraudulent Transfers and Obligations: Issues of Current Interest*, 43 S.C. L. Rev. 709, 736-38 (1992). Section 546(a)(1) represents a departure from prior law because the tolling provisions of Chapters X, XI, XII of the Bankruptcy Act did not survive the enactment of chapter 11 of the Bankruptcy Code. *Id.* at 739. The requirement that the trustee initiate suit within the two-year period was the only change. *Id.* at 740. "It is equally clear that Congress did not intend to go further and eliminate the tolling provisions that have existed since the first corporate reorganization statute that allowed the debtor to remain in possession." *Id.* at 739. *See also* 4 Collier on Bankruptcy ¶ 546.02 at 546-8 to 546-10 (15th ed. 1994).

The "plain meaning" interpretation of the pre-1994 Act version of section 546(a)(1) applied by the Fourth Circuit and rejected by the four other circuits is therefore not only compelled by the language of the section but also is the only one consistent with the statutory scheme of the Bankruptcy Code and the intent of its drafters. This Court should grant the petition to resolve the conflict among the circuits and correct the error of the Court below.

II. The Question of Whether Debtors-in-Possession Are Bound by the Section 546(a) Two-Year Statute of Limitations Period Is An Important Unsettled Question of Federal Law

In passing the Bankruptcy Reform Act of 1994, Congress has recognized the importance of a clear bankruptcy law scheme that courts can apply with certainty and administer efficiently:

> Without bankruptcy reform, companies, creditors, and debtors alike will continue to be placed on endless hold until their rights and obligations are

> adjudicated under the present system—and that slows down new ventures, new extensions of credit, and new investments . . . .
>
> * * *
>
> Bankruptcy filings declined last year after eight consecutive years of significant increases, but the 1993 total nevertheless exceeded 875,000—more than double the 1985 figure. In view of these statistics—and the reality that some business bankruptcies in recent years have involved literally billions of dollars and thousand of jobs—the profound economic consequences of bankruptcy cannot be overlooked. We must meet the challenge of reducing bankruptcy delays, discouraging abuses of the bankruptcy law process, and resolving the bankruptcy law problems that needlessly burden American businesses.

140 Cong. Rec. H10764 & 10772 (daily ed. Oct. 4, 1994) (statements of Reps. Brooks and Fish, respectively). Consistent with the stated goal of Congress, the amendment to section 546(a)(1) effected by the 1994 Act ensures that debtors and creditors involved in future bankruptcy cases will not encounter the litigation risks and delays associated with a statute of limitations interpreted by courts in more than one way. The conflict among the judiciary over the meaning of the pre-1994 Act version of section 546(a)(1), however, will continue to complicate and delay many chapter 11 cases pending on the date of the enactment of the 1994 Act.

This Court recently expressed serious concern over wasted judicial resources in a similar case involving the interpretation of another unambiguous provision of the Bankruptcy Code:

> It is regrettable that we have a legal culture in which such arguments have to be addressed (and

> are indeed credited by a Court of Appeals), with respect to a statute utterly devoid of language that could remotely be thought to distinguish between long-term and short-term debt. Since there was no contention of a "scrivener's error" producing an absurd result, the plain text of the statute should have made this litigation unnecessary and unmaintainable.

Union Bank, 112 S. Ct. at 534 (Scalia, J., concurring). Despite the clear language of section 546(a)(1), the question of whether the two-year statute of limitations period applies to debtors-in-possession has not only generated a sharp controversy among the courts of appeal in five circuits but has also spawned conflicting decisions by the lower courts in the other six circuits. Indeed, in circuits where there is no binding decision by the court of appeals, the bankruptcy courts and the district courts are divided, although the majority of these courts have followed the Fourth Circuit's interpretation.[17/]

[17/] *Compare Brin-Mont Chems., Inc.* v. *Worth Chem. Corp.* (*In re Brin-Mont Chemicals, Inc.*), 154 B.R. 903, 905 (M.D.N.C. 1993) (section 546(a)(1) does not apply to debtors in possession); *accord Crumley* v. *Tomen Am., Inc.* (*In re National Steel Serv. Center, Inc.*), 170 B.R. 745 (Bankr. N.D. Ga. 1994); *Tidwell v. Bank South (In re Denver/Robins Venture Partners, Ltd.)*, 166 B.R. 769, 773 (Bankr. M.D. Ga. 1994); *Official Unsecured Creditors' Comm.* v. *Leviton Mfg. Co.* (*In re Electric Materials Co.*), 160 B.R. 1018, 1023 (Bankr. W.D. Mo. 1993); *Saccurato* v. *Shawmut Bank* (*In re Mars Stores, Inc.*), 150 B.R. 869, 878 (Bankr. D. Mass. 1993); *Cardullo* v. *Dwyer Mech. Corp.* (*In re Cardullo*), 142 B.R. 138, 139 (Bankr. E.D. Va. 1992); *Freedom Ford, Inc.* v. *Sun Bank & Trust Co.* (*In re Freedom Ford, Inc.*), 140 B.R. 585, 587 (Bankr. M.D. Fla. 1992); *Pate* v. *Hunt* (*In re Hunt*), 136 B.R. 437, 446–47 (Bankr. N.D. Tex. 1991); *Pullman Constr. Indus.* v. *National Steel Serv. Center* (*In re Pullman Constr. Indus., Inc.*), 132 B.R. 359, (continued...)

In circuits where no court of appeals has ruled and the lower courts are divided on the issue, the widespread uncertainty among litigants as to which limitations period applies to debtors-in-possession is resulting in enormous amounts of wasteful litigation. In some chapter 11 cases, one avoidance action may involve millions of dollars, constituting the most valuable asset of the estate and the primary source of distributions for creditors. In other cases, a debtor-in-possession may have identified thousands of potential preference or fraudulent conveyance claims. In either instance, a debtor may place its chances for successful reorganization in serious jeopardy by prematurely commencing litigation before consensual plan arrangements with creditors have been reached.

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[17](...continued)
364 (Bankr. N.D. Ill. 1991); *Mancuso* v. *Continental Bank* (*In re Topcor, Inc.*), 132 B.R. 119, 124 (Bankr. N.D. Tex. 1991); *Keaton* v. *International Bank* (*In re Tamiami Range & Gun Shop, Inc.*), 130 B.R. 617, 619 (Bankr. S.D. Fla. 1991); *In re Revco D.S., Inc.*, 118 B.R. 468, 497 (Bankr. N.D. Ohio 1990); *Jet Florida, Inc.* v. *American Airlines, Inc.* (*In re Jet Florida Sys., Inc.*), 73 B.R. 552, 556 (Bankr. S.D. Fla. 1987); *Steel, Inc.* v. *Windstein*, 55 B.R. 426, 430 (Bankr. E.D. La. 1985); *Edleman* v. *Gleason* (*In re Silver Mill Frozen Foods, Inc.*), 23 B.R. 179, 181 (Bankr. W.D. Mich. 1982); *Knox Mktg. Co.* v. *Addington & Assocs.* (*In re One Mktg. Co.*), 17 B.R. 738, 740 (Bankr. S.D. Tex. 1982); *with Harstad* v. *Egan & Sons Co.* (*In re Harstad*), 170 B.R. 666 (D. Minn. 1994) (section 546(a)(1) applies to debtors in possession); *accord Sparmal Enters., Inc.* v. *Moffit Realty Corp.* (*In re Sparmal Enters., Inc.*), 126 B.R. 559, 562 (S.D. Ind. 1991); *Grabscheid* v. *Knox Metals Corp.* (*In re Luria Steel & Trading Corp.*), 168 B.R. 913, 916 (Bankr. N.D. Ill. 1994); *Official Comm. of Unsecured Creditors* v. *Four-O-Fluid Power Sales, Inc.* (*In re Hupp Indus., Inc.*), 165 B.R. 836, 839 (Bankr. N.D. Ohio 1994); *Knapp* v. *Applewhite* (*In re Knapp*), 146 B.R. 294, 296 (Bankr. M.D. Fla. 1992); *Lill* v. *Bricker* (*In re Lill*), 116 B.R. 543, 546 (Bankr. N.D. Ohio 1990).

For that reason, a debtor-in-possession, in the exercise of its fiduciary duty, would normally take the time, before filing suit, to weigh carefully the merits of its potential claims, on the one hand, against the impact of such litigation on its postconfirmation business relationships and the costs of such litigation, on the other hand. However, with the spectre of a two-year deadline, debtors-in-possession in circuits where the rule is unclear are placed in the difficult position of having to decide whether to wait and gamble on the chance that their potential claims will not later be dismissed as time-barred, or to pursue avoidance claims before their aforementioned analysis is complete. In most such cases, numerous lawsuits are launched or tolling agreements are negotiated at great expense to the estate.[18/] Many of those lawsuits ultimately prove to be without merit or are discontinued during the plan confirmation process. Moreover, while avoidance claims are investigated and pursued, management is distracted and important chapter 11 tasks are ignored, creditor relationships are strained, consensual deals jeopardized, and administrative priority expenses escalate.

Only this Court can eliminate the confusion among and within the circuits, and thereby cure the dilemmas and inequities now faced by countless debtors, by ensuring that the pre-1994 Act version of section 546(a)(1) is applied with uniformity in the many bankruptcy cases pending as of the date of the enactment of the 1994 Act.

[18/] It should be noted that at least one court has held that section 546 is "jurisdictional" and, therefore, that the two-year period cannot be tolled by agreement. *Martin* v. *First Nat'l Bank of Louisville (In re Butcher)*, 829 F.2d 596, 600 (6th Cir. 1987), *cert. denied*, 484 U.S. 1078 (1988). However, the 1994 Act's legislative history states that section 546 can be tolled by agreement. H.R. Rep. No. 103-835, 103d Cong., 2d Sess. 49-50 (1994).

CONCLUSION

For the reasons stated above, a writ of certiorari should be granted.

Dated: October 25, 1994

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 1992 - August Term 1993

(Argued July 19, 1994 Decided July 28, 1994)

Docket No. 94-5018

IN RE: McLEAN INDUSTRIES, INC.,

Debtor,

UNITED STATES LINES (S.A.), INC.,

Plaintiff-Appellee,

– v. –

UNITED STATES OF AMERICA,

Defendant-Appellant.

Before: WALKER, McLAUGHLIN, and JACOBS,
Circuit Judges.

The United States of America, acting through its agency the Maritime Administration, appeals a judgment of the United States District Court for the Southern District of New York (Duffy, J.), 162 B.R. 410 (S.D.N.Y. 1993), which affirmed the Bankruptcy Court's order (Blackshear, B.J.), 132 B.R. 247 (Bankr. S.D.N.Y. 1991), granting summary judgment to the

plaintiff on the basis that a pre-petition transfer constituted a voidable preference under 11 U.S.C. § 547.

Reversed and remanded.

JOHN T. STEMPLEWICZ, Washington, DC (Frank W. Hunger, J. Christopher Kohn, Tracy T. Whitaker, Civil Division, U.S. Department of Justice, of counsel), for *Defendant-Appellant*.

ROBERT D. DRAIN, New York, NY (Paul, Weiss, Rifkind, Wharton & Garrison, of counsel), for *Plaintiff-Appellee*.

Per Curiam:

The United States of America, acting through its agency the Maritime Administration ("MARAD"), appeals a judgment of the United States District Court for the Southern District of New York (Kevin Thomas Duffy, *Judge*), 162 B.R. 410 (S.D.N.Y. 1993), which affirmed the order of the Bankruptcy Court (Cornelius Blackshear, *Bankruptcy Judge*), 132 B.R. 247 (Bankr. S.D.N.Y. 1991), granting summary judgment to the plaintiff USL Reorganization Trust, successor in interest to United States Lines (S.A.), Inc. ("USL"), on the basis that a pre-petition transfer to MARAD constituted a voidable preference under 11 U.S.C. § 547. For the reasons that follow, we reverse that judgment and remand for further proceedings consistent with this opinion.

We recount only those facts relevant for the disposition of this appeal and direct those with greater curiosity to the thorough published opinions in the bankruptcy and district courts. USL owned three ships in which MARAD had a first priority, but undersecured, mortgage. These ships sat dormant in 1986, until another shipping company, Lykes Brothers Steamship Company ("Lykes"), proposed to charter these vessels from USL. USL's financial agreements with MARAD required that USL obtain MARAD's approval for any such arrangement. USL and Lykes sought MARAD's approval of the deal, which would have preserved certain tax benefit transfer leases ("TBT leases") for USL as well as provided operating subsidies for Lykes. MARAD agreed to consent provided that USL assign the charters to MARAD. Under the assignment devised by the parties, Lykes would pay the "charter hire," that is, the fees for use of the ships, to an intermediary party, Chemical Bank. As long as MARAD received no demand upon its mortgage guarantees, Chemical's instructions were to forward the fees to USL. However, upon receipt by Chemical of notice from MARAD of such a demand, Chemical was to hold further payments from Lykes pending MARAD's instructions. This deal, consummated on November 4,

1986, is the transfer that USL seeks to avoid as a preference under § 547(b) of the Bankruptcy Code.

On November 24, 1986, USL filed for reorganization under Chapter 11 of the Bankruptcy Code. In early 1987, MARAD received a demand upon its mortgage guarantees and notified Chemical. In accordance with the November 4, 1986 agreement, Chemical thereafter retained all fees paid by Lykes. Recognizing that continuation of the charters would benefit USL by maintaining the TBT leases, MARAD and USL sought to enter a stipulation in the bankruptcy court memorializing the charters. However, the bankruptcy court never gave its required approval because of an unrelated objection to the pact advanced by Chemical. At the end of the initial one-year charter term of Lykes, MARAD agreed to extend the charter and accompanying subsidies for two more years.

In May 1989, the bankruptcy court confirmed USL's plan of reorganization, under which USL, as debtor-in-possession, formally assumed the charters pursuant to 11 U.S.C. § 365. The plan made not specific mention of the charter assignment being voidable or the charter hire being available to USL's creditors.

Several months after confirmation of the reorganization plan, and two years and ten months after its Chapter 11 filing, USL brought this avoidance action pursuant to 11 U.S.C. § 547. MARAD objected to the avoidance action on numerous grounds, including the argument that USL waited too long to bring the avoidance action and should be estopped from attempting to avoid the charter assignment. MARAD argued that USL's belated change of position prejudiced MARAD during the pendency of the reorganization. By consenting to the charters, and their subsequent extension, MARAD preserved for USL the benefit of the TBT leases as well as expended over $36 million in subsidies to Lykes. Further, MARAD contended that USL's agreement with MARAD to memorialize the charter assignment in the bankruptcy court by

stipulation, though never formally ratified by that court, should estop any attempt to avoid the assignment.

USL responded to MARAD's timeliness argument by citing § 546(a) of the Code, which states that an avoidance action may be brought no later than the earlier of "(1) two years after the appointment of a trustee" or "(2) the time the case is closed or dismissed." 11 U.S.C. § 546(a). Because USL was a debtor-in-possession, no formal "trustee" was appointed. Thus, relying principally upon *Korvettes, Inc.* v. *Sanyo Electronics (In Re Korvettes, Inc.)*, 67 B.R. 730, 734 (S.D.N.Y. 1986), which held that § 546(a)(1) did not apply in debtor-in-possession cases, USL argued that § 546(a)(2) allowed an avoidance claim to be commenced anytime before its case was "closed or dismissed." The bankruptcy court agreed, citing *Korvettes*, and held that USL's claim was timely. *See* 132 B.R. at 256.

In the district court, MARAD reiterated its timeliness/estoppel argument. Although not formally raising § 546(a)'s statute of limitations provision, MARAD asserted in its brief before the district court that USL was estopped from challenging the assignment by its continued reassurances and by waiting "until it was too late for MARAD to pursue available alternatives." Finally, in its opening brief to this court, MARAD once again pressed its claim that "USL [should be] estopped from pursuing its avoidance claims where it failed to act earlier."

A few days after MARAD submitted its opening brief, this court decided *U.S. Brass & Copper Co.* v. *Caplan (In re Century Brass Products, Inc.)*, 22 F.3d 37 (2d Cir. 1994). After a careful review of the statutory language and legislative history, we held for the first time in this Circuit that the "appointment of a trustee" in § 546(a)(1) was equivalent to the filing of a petition in debtor-in-possession cases (in which there is no trustee). *Id.* at 40. Thus, *Century Brass* overruled *Korvettes* and similar lower court authority that had held that § 546(a)(1)'s two-year limitation did not apply to debtor-in-possession cases.

MARAD promptly notified this panel and USL of the *Century Brass* decision in a letter submitted pursuant to Fed. R. App. P. 28(j), thereby allowing USL to address the implications of *Century Brass* in its brief. USL, apparently recognizing that the rule announced in *Century Brass* would control this case, argued that MARAD waived its right to rely on § 546(a) by failing to specifically press this claim throughout the litigation. Thus, the issue we must decide is whether MARAD adequately preserved the § 546(a) statute of limitations issue for consideration on this appeal. We believe that it did.

We note at the outset "our review of the district court's decision is plenary," and we thus "independently examine the bankruptcy court's decision, applying the clearly erroneous standard to findings of fact and *de novo* review to conclusions of law." *Klein* v. *Civale & Trovato, Inc. (In re: The Lionel Corp.)*, No. 93-5085, 1994 WL 361093, at *4 (2d Cir. July 12, 1994).

In this Circuit, we reserve "considerable discretion" to review purely legal questions not formally raised in the district court. *See Austin* v. *Healey*, 5 F.3d 598, 601 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1192 (1994); *see also United States* v. *16.03 Acres of Land*, No. 92-6201, 1994 WL 259505, at *3 (2d Cir. June 14, 1994) (same); *Bornholdt* v. *Brady*, 869 F.2d 57, 68 (2d Cir. 1989) (same). Moreover, we have made plain that "[a]rguments made on appeal need not be identical to those made below if they involve only questions of law and additional findings of fact are not required." *A.I. Trade Finance* v. *Petra Bank*, 989 F.2d 76, 80 (2d Cir. 1993) (citing *Vintero Corp.* v. *Corporacion Venezolana de Fomento*, 675 F.2d 513, 515 (2d. Cir. 1982)).

In this case, we believe that MARAD adequately preserved its right to press the § 546(a) statute of limitations claim on this appeal. Since the outset of USL's preference avoidance claim, MARAD has consistently argued that it has been prejudiced by USL's delay in bringing the action. MARAD's argument in the bankruptcy court was rebuffed on the authority of *Korvettes*.

MARAD repeated its plea before the district court and was similarly turned away. MARAD reiterated this claim for a third time in this court days before we handed down *Century Brass*. Although we fully appreciate that MARAD did not precisely assert its timeliness defense as one under the statute of limitations, the fact that the timeliness of the avoidance action has been in the case from the outset removes any hesitation we might have in exercising our discretion to consider the purely legal question presented by MARAD's § 546(a) claim.

On the authority of *Century Brass*, we hold that USL's preference avoidance action was not brought within the applicable two-year limitations period and therefore reverse the judgment of the district court. We express no view as to the correctness of the other rulings of the courts below.

USL argues that even if *Century Brass* applies, 11 U.S.C. § 502(d) still prevents MARAD from reaping the alleged benefit of the assignment. Section 502(d) states:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

Section 502(d) requires a court to disallow an entity's claim against the bankruptcy estate if the estate is entitled to recover property from that entity, such as because of a voidable preference, but that entity has failed to first transfer this property back to the bankruptcy estate. *See, e.g., Campbell* v. *United States (In re Davis)*, 889 F.2d 658, 662 (5th Cir. 1989), *cert. denied*, 495 U.S. 933 (1990). USL argues that the timeliness of its preference

claim is irrelevant for the purposes of § 502(d), and that MARAD cannot benefit from its alleged preference and still make other claims against USL. *Compare In re Mid Atlantic Fund, Inc.*, 60 B.R. 604, 610-11 (Bankr. S.D.N.Y. 1986) (holding that two-year limitation period did not prevent trustee from relying defensively on § 502(d)) *with In re Marketing Assocs. of Am., Inc.*, 122 B.R. 367, 369 (Bankr. E.D. Mo. 1991) (explicitly rejecting *Mid Atlantic* and holding that the plain language of § 502(d) did not permit defensive reliance on an otherwise time-barred preference). Because this issue has not been adequately briefed in this court and may require facts outside of the record, we express no opinion on this issue but remand to the bankruptcy court for the limited purpose of considering in the first instance USL's argument based upon § 502(d).

Reversed and remanded.

UNITED STATES COURT OF APPEALS
for the SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 28th day of July, one thousand nine hundred and ninety-four.

PRESENT: HON. JOHN M. WALKER,
HON. JOSEPH M. MCLAUGHLIN,
HON. DENNIS G. JACOBS,
Circuit Judges.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	
McLEAN INDUSTRIES, INC., et al.,	:	
Debtors.	:	
UNITED STATES LINES (S.A.), INC.,	:	91 Civil 7543 (KTD) JUDGMENT
Plaintiff-Appellee,	:	
-against-	:	
UNITED STATES OF AMERICA,	:	
Defendant-Appellant.	:	

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York and was argued by counsel.

On consideration whereof it hereby ordered, adjudged and decreed that the judgment of said district court be and it hereby is reversed and the action be and it hereby is remanded to the said district court for further proceedings in accordance with the opinion of this Court.

GEORGE LANGE III, Clerk
By: /s/ Edward J. Guardaro

Edward J. Guardaro,
Staff Attorney

ISSUED AS A MANDATE: August 18, 1994

UNITED STATES COURT OF APPEALS
Second Circuit
United States Courthouse
Foley Square
New York 10007

GEORGE LANGE III
Clerk

DATE: July 28, 1994
Re: United States Lines v. USA
Docket No.(s): 94-5018

Dear Counsel:

The court has handed down a decision in the above-entitled case. The decision of the district court has been

REVERSED AND REMANDED by published signed opinion.

A copy of the printed opinion will be mailed to you. Additional copies of the opinion may be obtained from this office in accordance with Section 0.17(7) of the rules of this court supplementing the Federal Rules of Appellate Procedure.

Judgment has been entered today and a mandate will issue in accordance with Rule 41 of the Federal Rules of Appellate Procedure.

Your attention is directed to the provision of Rule 39(c) of the Federal Rules of Appellate Procedure requiring the itemized

and verified bill of costs, if any, to be filed with proof of service, within 14 days after entry of judgment.

Very truly yours,

GEORGE LANGE III, Clerk
By: Donna J. Morgan

/s/ Donna Morgan
Deputy Clerk

In re McLean Industries,
Inc., et al., Debtors.

United States Lines (S.A.),
Inc., Plaintiff-Appellee,

v.

United States of America,
Defendant-Appellant.

No. 91 Civ. 7543 (KTD)

United States District Court,
S.D. New York

Dec. 17, 1993

As Amended Dec. 22, 1993

Vessel owner which had filed for Chapter 11 relief brought preference proceeding to avoid its assignment of interest in charter hire funds to United States Maritime Administration. The Bankruptcy Court, Cornelius Blackshear, J., 132 B.R. 247, entered judgment in favor of vessel owner, and Maritime Administration appealed. The District Court, Kevin Thomas Duffy, J., held that: (1) Maritime Administration waived its sovereign immunity as to vessel owner's preference claims by filing proof of claim in Chapter 11 case; (2) earmark doctrine did not apply to protect alleged preferential transfer of charter hire funds to Maritime Administration; and (3) Maritime Administration's forbearance, in declining to exercise its contractual right as ship mortgagee to prevent vessel owner from entering into bareboat charter of vessels, did not constitute "new value" supporting vessel owner's assignment of interest in charter hire funds.

Affirmed.

Milbank, Tweed, Hadley & McCloy (Robert Drain, of counsel), New York City, for plaintiff-appellee USL Reorganization Trust.

Mary Jo White, U.S. Atty. (Edward A. Smith, Asst. U.S. Atty., of counsel), New York City, and J. Christopher Kohn, Tracy J. Whitaker and John T. Stemplewicz, Attys., Civ. Div., Dept. of Justice (Richard M. Lorr, Maritime Admin., of counsel), Washington, DC, for defendant-appellant U.S.

MEMORANDUM & ORDER

KEVIN THOMAS DUFFY, District Judge.

Appellant, The United States of America on behalf of the Maritime Administration ("Marad"), Department of Transportation, appeals to this court, pursuant to 28 U.S.C. § 158(a), from an Order of the United States Bankruptcy Court for the Southern District of New York, Cornelius Blackshear, J., granting the USL Reorganization Trust's ("Debtor"), successor in interest to United States Lines (S.A.), Inc., Motion for Summary Judgment and denying Marad's Motion for Summary Judgment. *See United States Lines (S.A.), Inc.* v. *United States* (*In re McLean Indus., Inc.*), 132 B.R. 247, 267 (Bankr. S.D.N.Y. 1991) (hereinafter "*McLean*"). The decision of the Bankruptcy Court is hereby affirmed in its entirety.

BACKGROUND

The facts of this case are uncontroverted as they are based on an agreed Pre-trial Order, and they are generally set forth in

McLean, 132 B.R. at 250-54. The following factual summary recites only those facts pertinent to this appeal.[1/]

Moore-McCormack Liners, Inc. ("Moore-McCormack") owned three vessels: (1) S.S. AMERICAN ARGO; (2) S.S. AMERICAN RIGEL; and (3) S.S. AMERICAN VEGA (collectively the "Vessels"). Construction of these Vessels was largely financed by federal programs administered by Marad in 1964 and 1965. Marad paid $15 million to Moore-McCormack as a construction-differential subsidy in 1962 (the "1962 CDS"). Additionally, in 1967, Moore-McCormack issued bonds totaling $11,526,000 due April 1, 1987. These bonds were secured by a first preferred ship mortgage on each Vessel (the "1967 Mortgage"). More importantly, the 1967 Mortgage was insured by Marad pursuant to subchapter XI of Merchant Marine Act. 46 U.S.C. App. §§ 1271 *et seq.* Moore-McCormack also received an operating-differential subsidy ("ODS") for the Vessels as authorized by subchapter VI of the Merchant Marine Act. 46 U.S.C. App. §§ 1171 *et seq.*

In 1981, the Vessels underwent extensive modifications, costing approximately $54 million. Marad partly financed these modifications with another construction-differential subsidy (the "1981 CDS"). Marad also guaranteed another issue of bonds by Moore-McCormack, totaling $34,300,000 (collectively with the 1967 guarantee, the "Guarantees" or "Insured Bonds"). The second issue of Insured Bonds was secured by another preferred fleet mortgage in 1983 (the "1983 Mortgage").

In early 1983, McLean Securities, Inc., the parent of United States Lines, Inc., acquired Moore-McCormack and

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[1/] Both parties agree that no genuine issue of material fact exists and that the Bankruptcy Court was correct in ruling on the merits of the summary judgment motions. *See* Fed. R. Civ. P. 56(c); *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 247-48, 106 S. Ct. 2505, 2509-10, 91 L. Ed. 2d 202 (1986).

renamed it United States Lines (S.A.), Inc. ("USL"). In order to finance the acquisition, Chemical Bank ("Chemical") loaned $50 million to be partially secured by a preferred fleet mortgage on the Vessels. Chemical's fleet mortgage was subordinate to the 1967 Mortgage and the 1983 Mortgage.

In 1986, as part of a debt restructuring plan prompted by large operating losses, USL requested that Marad and the holders of the Insured Bonds defer the principal payment due June 30, 1986 on the 1983 Mortgage. Marad and the bondholders agreed to defer the payment until June 30, 1988. In return, however, USL agreed to amend the security agreement under the 1983 Mortgage to include certain additional security default covenants (the "Amended Security Agreement").

The Amended Security Agreement contained a covenant requiring USL to obtain Marad's consent prior to bareboat chartering the Vessels.[2/] This same restrictive covenant was included in the 1967 Mortgage, the 1981 CDS, UL's ODS, as well as the Reserve Fund and Financial Agreement entered into concurrently with the 1983 Mortgage. None of these agreements, however, restricted Marad's power to consent to a bareboat charter of the Vessels.

On August 15, 1986, USL applied for Marad's consent to a proposed bareboat charter of the Vessels to the Lykes Brothers Steamship Company ("Lykes"). For the previous nine months, USL had not used any of the Vessels for its own operations. In September 1986, USL and Lykes entered into a formal charter agreement ("Agreement to Charter") providing for a three-year bareboat charter of the Vessels. The Agreement to Charter was

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[2/] In a bareboat charter, the charteree takes complete control over the ship for a specified period of time. The shipowner, in return, receives charter hire, i.e. the agreed payment for the ship's use. *See generally* Grant Gilmore & Charles L. Black, Jr., *The Law of Admiralty* 239-43 (2d ed. 1975).

conditioned expressly upon marad's consent to USL chartering the Vessels to Lykes.

On October 16, 1986, Marad agreed to consent to the Agreement to Charter subject to certain conditions. Primarily, Marad required an assignment of the charters as additional security for its mortgages on the Vessels. The facts indicate that Marad would not have consented without such an assignment. On November 4, 1986, the parties entered into four agreements: (1) three bareboat charter parties between USL and Lykes (the "Charters"); (2) a Charter Assignment and Agreement between USL, Lykes, and Marad (the "Assignment"); (3) a Depository Agreement between Marad and Chemical (the "Depository Agreement"); and (4) an Agreement between Marad and Lykes ("Marad/Lykes Agreement"), which acknowledged Marad's mortgages and its interest in the Charters.

The Charters required that the charter hire be paid to Chemical "for credit to the account of" Marad pursuant to the Assignment. Under the Assignment, USL granted Marad a security interest in its Charters and the charter hire payments to be received from Lykes. It is this transfer from USL to Marad that the Debtor seeks to avoid as a preference under § 547(b) of the Bankruptcy Code. 11 U.S.C. § 547(b).

Pursuant to the Charter, Chemical agreed to receive the charter hire payments under the Depository Agreement. Chemical was to transfer to USL any charter hire paid by Lykes no later than one business day after the funds became available. If Marad notified Chemical of a demand upon the Guarantees, Chemical was to hold charter hire payments subject to Marad's instructions.

On November 24, 1986 ("Petition Date"), USL filed its voluntary petition under Chapter 11 of Title 11 of the Bankruptcy Code; however, it continued to operate its business as a debtor-in-possession in accordance with § 1107 of the Code. 11 U.S.C. § 1107. Debtor (formerly USL) made no payment on the Insured

Bonds after the Petition Date. On February 26, 1987, Marad received the first demand upon the Guarantees. Pursuant to the Depository Agreement, Marad instructed Chemical to hold for Marad's account all charter hire deposited by Lykes. Chemical stopped transferring charter hire deposits to Debtor but refused to transfer the deposits directly to Marad without a court order.

After discussions between Debtor and Marad, Debtor acknowledged that Marad should receive all the charter hire that Lykes paid after Marad received the demand on its guarantees, including the charter hire paid prior to Marad's notification to Chemical of the demand upon the Guarantees. Marad and the Debtor signed a Stipulation and Order Providing for Repayment of charter hire (the "Stipulation") requiring Chemical to disburse all Lykes charter hire as Marad may direct. It also provided that the Debtor would pay Marad $126,000 for charter hire transferred to the Debtor after Marad received the demand upon the Guarantees but before Marad notified Chemical of that demand. The Stipulation was conditioned only upon court approval, and the parties set no time limit for obtaining the requisite court approval.

At a hearing to approve the Stipulation, Chemical, as a creditor, objected to the Stipulation. The hearing was adjourned pending further resolution of Chemical's objection. Marad and Chemical attempted to negotiate a settlement of Chemical's objection to the Stipulation, but they failed to do so. Chemical, nevertheless, did agree to pay interest on the depository account while the matter was pending.

On December 31, 1987, Marad filed a proof of claim for amounts due on the 1967 Mortgage and the 1983 Mortgage. The proof of claim included as a set off the charter hire that Chemical held in the depository account. The Debtor never contested the validity, priority, or amount of Marad's mortgages on the Vessels, and the 1967 and 1983 Mortgages were valid and perfected preferred mortgages under Ship Mortgage Act. 46 U.S.C. App.

§ 911 *et seq.* As a result of its debts and these mortgages, the Debtor had no equity in the Vessels.

On March 23, 1989, USL's Second Amended and Restated Disclosure Statement (the "Disclosure Statement") was approved by the Bankruptcy Court. On May 16, 1989, the Debtor's First Amended and Restated Joint Plan of Reorganization (the "Plan") was confirmed. In the Plan, the Debtor unqualifiedly assumed the Charters, which still required payment of the charter hire to Chemical. Marad did not object to the confirmation of the Plan or to the assumption of the Charters.

The Debtor then brought an adversary proceeding before the Bankruptcy Court claiming that the [sic] Marad must pay Debtor's bankruptcy estate approximately $10 million as an alleged avoidable preference and/or a fraudulent conveyance.[2] The Debtor moved for summary judgment on its claims, and Marad cross-moved for summary judgment. The Bankruptcy Court granted the Debtor's motion and denied Marad's cross-motion. Marad appealed in a timely manner and obtained a stay pending this appeal. For the following reasons, the Bankruptcy Court's decision is affirmed in its entirety.

ISSUES ON APPEAL

The issues raised by this appeal are:

(1) whether Marad waived sovereign immunity when it

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[2] The Debtor included a fraudulent conveyance claim in its complaint; however, the Debtor did not move for summary judgment on the fraudulent conveyance claim. Marad did move to dismiss the fraudulent conveyance claim. The Bankruptcy Court denied Marad's motion because it based its ruling entirely on the avoidable preference claim. *McLean*, 132 B.R. at 256-57. In any event, neither party raised the fraudulent conveyance issue on this appeal; therefore, I will not address it.

filed the proof of claim so as to allow the Debtor to initiate an adversary proceeding;

(2) whether the Assignment by USL to Marad constituted an avoidable preference under § 547(b) of the Bankruptcy Court;

(a) whether the charter hire funds were part of the Debtor's estate for voidable preference purposes;

(b) whether Marad received more from the Assignment than it would have received in a Chapter 7 Liquidation proceeding;

(3) whether the "new value" and/or the "improvement in position" exceptions apply so as to make the Assignment non-voidable;

(4) whether the Debtor's assumption of the Charter ratified the Assignment, thereby barring the Debtor's avoidance claim; and

(5) whether the Debtor is estopped from pursuing a preference avoidance claim against Marad after the Debtor represented to Marad in the Stipulation and the Disclosure Statement that Marad was entitled to the charter hire.

I will address these issues seriatim.[4]

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[4] Findings of fact by a bankruptcy court cannot be set aside unless they are clearly erroneous. Bankr. R. 8013. A bankruptcy court's conclusions of law are subject to *de novo* review. *See In re O.P.M. Leasing Serv., Inc.*, 79 B.R. 161, 162 (S.D.N.Y. 1987). Mixed questions of law and fact are also reviewed *de novo*. *See In re Maitlen*, 658 F.2d 466, 470 (7th Cir. 1981). Since the issues here are either purely legal or mixed questions of law and fact, I will review this appeal *de novo*.

DISCUSSION

(1) Sovereign Immunity

The Bankruptcy Court ruled that sovereign immunity was waived when Marad filed a proof of claim to set off its debt against the money then held by Chemical in the Depository Account. *McLean*, 132 B.R. at 254-55. Marad contends that it did not assert a claim to the charter hire and that the Bankruptcy Court's characterization as such was flawed.

In general, the United States enjoys sovereign immunity from suit unless it expressly waives such immunity and consents to be sued. *United States* v. *Mitchell*, 445 U.S. 535, 538, 100 S. Ct. 1349, 1351, 63 L. Ed. 2d 607 (1980); *United States* v. *King*, 395 U.S. 1, 4, 89 S. Ct. 1501, 1502, 23 L. Ed. 2d 52 (1969). A waiver of sovereign immunity to be effective must be "unequivocally expressed." *Irwin* v. *Department of Veterans Affairs*, 498 U.S. 89, 95, 111 S. Ct. 453, 457, 112 L. Ed. 2d 435 (1990).

Congress provided a limited waiver of sovereign immunity in bankruptcy cases in 11 U.S.C. § 106(a), which states:

> A governmental unit is deemed to have waived sovereign immunity with respect to any claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which such governmental unit's claim arose.

11 U.S.C. § 106(a). The Supreme Court recently stated that § 106(a) created an unequivocal waiver. *United States* v. *Nordic Village*, _____ U.S. _____, _____, 112 S. Ct. 1011, 1015, 117 L. Ed. 2d 181 (1992). With § 106(a), Congress plainly waived "sovereign immunity with regard to monetary relief in...compulsory counterclaims to government claims." *Id.* The legislative

history to § 106(a) indicates that the purpose behind the statute was to prevent a governmental unit from receiving property of the debtor's estate without subjecting itself to potential liability to the estate. H.R. Rep. No. 595, 95th Cong., 1st Sess. 317 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6274 (hereinafter "House Report"). Therefore, it is clear that § 106(a) establishes a waiver of sovereign immunity.[1]

A waiver of sovereign immunity under § 106(a) is, however, limited. A debtor's claim against the government must arise out of the same transaction or occurrence that is the subject of the government's claim against the estate. *995 Fifth Avenue Assoc., L.P.* v. *New York State Dep't of Taxation and Finance* (*In re 995 Fifth Avenue Associates, L.P.*), 963 F.2d 503, 507-08 (2d Cir.), *cert. denied*, _____ U.S. _____, 113 S. Ct. 395, 121 L. Ed. 2d 302 (1992). Several courts have construed the standard found in § 106(a) in a similar manner to the compulsory counterclaim rule found in Rule 13(a) of the Federal Rules of Civil Procedure.[2] *See In re University Medical Center*, 973 F.2d

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[1] Counsel for Debtor raised an argument that Marad also waived its rights through 11 U.S.C. § 106(c). Since this appeal was initiated, the Supreme Court has ruled that § 106(c) does not create a waiver of sovereign immunity in actions involving monetary recovery in bankruptcy. *Nordic Village*, _____ U.S. at _____, 112 S. Ct. at 1016-17. Thus, Debtor's argument that § 106(c) creates a waiver here must fail. Recognizing this point, counsel for Debtor has seemingly withdrawn the argument. *See* Letter from Debtor's Counsel, dated March 17, 1993 at 2 n.1. Therefore, I will only address the application of § 106(a) to this case.

[2] Fed. R. Civ. P. 13(a) states:

> A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does

(continued...)

1065, 1086 (3d Cir. 1992); *WJM, Inc.* v. *Massachusetts Dep't of Public Welfare*, 840 F.2d 996, 1005 (1st Cir. 1988). The Court of Appeals for the Second Circuit has neither explicitly rejected nor accepted this reasoning. It is, however, reasonable to conclude that the tests established for Rule 13(a) purposes are applicable for § 106(a) purposes as well.

The Second Circuit held that the State of New York waived its Eleventh Amendment immunity through § 106(a) when it filed an administrative expense claim in an adversarial bankruptcy proceeding. *995 Fifth Avenue Assoc.*, 963 F.2d at 509. In the adversarial proceeding, the debtor was seeking a tax refund on a gains tax levied on a sale of property. The State of New York filed an administrative expense claim seeking additional gains tax liability on the sale. The Second Circuit ruled that the original gains tax liability "arose out of the same transaction" as the administrative claim the government was making. *Id.*

This holding as well as the court's reliance on *WJM* illustrate that the test used for Rule 13(a) purposes is to be applied to § 106(a) inquiries as well. *Id.* Moreover, the legislative history of § 106(a) explains that "the filing of a proof of claim against the estate by a governmental unit is a waiver by that governmental unit of sovereign immunity with respect to compulsory counterclaims, *as defined in the Federal Rules of Civil Procedure*, that is counterclaims arising out of the same transaction or occurrence." S. Rep. No. 989, 95th Cong., 2d Sess. 29, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5815 (emphasis added). Thus, Congress intended § 106(a) to be interpreted similarly to Rule 13(a).

The test under Rule 13(a) is "whether the essential facts of the various claims are so logically connected that considerations

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[9](...continued)
not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction.

of judicial economy and fairness dictate that all the issues be resolved in one lawsuit." *Harris* v. *Steinem*, 571 F.2d 119, 123 (2d Cir. 1978). Furthermore, the Second Circuit interprets Rule 13(a) compulsory counterclaims broadly and has held that "a counterclaim is compulsory if it bears a 'logical relationship'—not necessarily an 'absolute identity of factual backgrounds' to the main claim." *United States* v. *Aquavella*, 615 F.2d 12, 22 (2d Cir. 1979).

Using these standards, the Bankruptcy Court held that Marad's mortgage claims and the Debtor's preference claims were "integrally related" and met the test set forth in *Harris*. *McLean*, 132 B.R. at 255. Marad's proof of claim and the Debtor's preference avoidance action seek the same property—the charter hire funds. Marad's proof of claim asserts an interest in the charter hire; the Debtor asserts that this interest is unenforceable. Applying the "logical relationship" test, it is clear that Marad's claim arose out of the same transaction or occurrence as the Debtor's claim. Therefore, the claims are logically related, and Marad waived sovereign immunity when it filed a proof of claim seeking the charter hire funds.

Marad argues that the proof of claim asserts a right to payment of its mortgage debt and, rather than asserting a claim to the charter hire, indicates that the charter hire is Marad's security for the debt. With this, Marad is actually arguing the merits of the avoidance claim. If the charter hire represents security for the original debt, then no transfer that can be avoided occurred. Were this the case, which as discussed below it is not, then Marad would prevail on the merits of the preference avoidance action. Whether sovereign immunity was waived or not does depend on the merits of the claims asserted. Instead, the issue for sovereign immunity is whether the claims themselves can be adjudicated. *See* House Report at 6274. Through § 106(a), Congress intended to prevent a governmental unit from a [sic] receiving a "distribution from the estate without subjecting itself to any [potential] liability it has to the estate arising from the transaction or occurrence upon

which its distribution is based." *In re Prudential Lines, Inc.*, 79 B.R. 167, 180 (Bankr. S.D.N.Y. 1987) (citations omitted).

Once Marad filed the proof of claim, it subjected itself to the adjudication of any action that the Debtor may have against Marad regarding the charter hire funds. The fact is that Marad's claim and the Debtor's claim both seek the same money—the money held by Chemical in the Depository Account. House Report at 6274. The claims are, therefore, logically connected so as to "arise out of the same transaction or occurrence." 11 U.S.C. § 106(a).

Marad also argues that the claims do not arise out of the same transaction or occurrence because they are each based on different contractual arrangements. Marad's claim is based on the 1967 and 1983 Mortgages, while the Debtor's claim is based on the Assignment. The logical relationship test does not require that the claims arise from the same agreement. *See generally Prudential Lines*, 79 B.R. at 171-74; 179-82. It only requires that the claims have a logical nexus. I cannot conceive of claims more logically related than those seeking the same property. Moreover, the Mortgages are, in fact, logically related to the Assignment. The Assignment represents a security interest in the charter hire received by USL from the chartering of ships upon which Marad held the Mortgages. Thus, by looking to the agreements rather than the property sought, the claims are logically related and arise out of the same transaction or occurrence.[2/]

[2/] Marad argues that I should apply the test set forth in *Brown* v. *United States* (*In re Rebel Coal Co.*), 944 F.2d 320 (6th Cir. 1991). The Court of Appeals for the Sixth Circuit applies a stricter standard than the "logical relationship" test. *Id.* at 321. The Second Circuit, however, applies the less stringent test for both § 106(a) and Rule 13(a) inquiries. *See 995 Fifth Avenue Assoc.*, 963 F.2d at 509; *Harris*, 571 F.2d at 123. I am, of course, bound to apply the Second Circuit's "logical relationship" test. *See United States* v. *Moore*, 949 F.2d 68, 71 (2d Cir.

(continued...)

The Bankruptcy Court was correct in ruling that Marad waived its sovereign immunity when it filed its proof of claim. Accordingly, the Bankruptcy Court's ruling is affirmed.

(2) **Preferential Transfer**

The Bankruptcy Court ruled that the Assignment was an avoidable transfer under § 547(b) of the Bankruptcy Code. *McLean*, 132 B.R. at 257-62. The prerequisites for a voidable preference begin with a threshold requirement that a voidable preference must involve "a transfer of an interest of the debtor in property..." 11 U.S.C. § 547(b). If such a transfer is involved, the transfer must also be:

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt;

(3) made while the debtor was insolvent;

(4) made on or within 90 days before the date of the filing of the petition; and

(5) one that enables the benefitted creditor to receive more than such creditor would have received had the case been a Chapter 7 liquidation and the creditor had not received the transfer.

[2/](...continued)
1991), *cert. denied sub nom.*, *Salami* v. *United States*, _____ U.S. _____, 112 S. Ct. 1678, 118 L. Ed. 2d 396 (1992). More importantly, I am bound by Congress' intent.

Id. It is undisputed that requirements (1) through (4) have been satisfied in this case.[4] Requirement (5) is in dispute, and I address that dispute below. The major dispute in the case centers around whether the transfer in question was a transfer of an interest of the debtor in property.

(a) Interest of the Debtor in Property

A transfer of assets is preferential under § 547(b) only if the property or the interest in the property transferred belongs to the debtor. 11 U.S.C. § 547(b). *See Coral Petroleum Inc.* v. *Banque Paribas-London*, 797 F.2d 1351, 1355-56 (5th Cir. 1986). The Bankruptcy Court ruled that the Charters and the charter hire funds were property belonging to USL, and therefore, the Assignment was a transfer that depleted the estate's assets. *McLean*, 132 B.R. at 259-62. Marad argues that the Charters and the charter hire funds were not property belonging to USL, and therefore, the Assignment did not deplete the Debtor's estate because: (1) USL's right to bareboat charter the Vessels was valueless to unsecured creditors absent Marad's consent to the Agreement to Charter; (2) the transfer was for assets over which the Debtor had no control; and/or (3) the Assignment merely continued Marad's pre-existing lien on the Debtor's possessory rights in the Vessels. All three arguments are without merit.

At the Petition Date, Lykes was paying the charter hire to USL for the rental value of the Vessels, pursuant to the Agreement to Charter, the Charters, and the Depository Agreement. As such, the Charters and the charter hire funds belonged to USL once Lykes and USL entered into the Agreement to Charter and Marad consented to this arrangement. Marad contends that without its consent the Charters and the charter hire would never have

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[4] The third requirement of the § 547(b) test was challenged by Marad in the Bankruptcy Court. *See McLean*, 132 B.R. at 257-59. It was, however, not raised on this appeal. Therefore, I will not address it.

existed; therefore, USL's right to bareboat charter was of no value to the general creditors of USL.

Whether the right to bareboat charter was of value to the general creditors is, however, irrelevant because this right was not the interest in property that was transferred when the Debtor entered into the Assignment. The Debtor, instead, transferred its right to receive the charter hire. While the right to bareboat charter, itself, may or may not be of value to the general creditors, the Charters and the charter hire funds are undoubtedly of value to them. Once Marad granted its consent, the Charters and the charter hire funds belonged to USL. Indeed, the charter hire funds made USL a more valuable company for all of its creditors, including Marad. Marad understood this, and with the Assignment, it attempted to keep this value for itself. The preference avoiding laws, however, prohibit such conduct.[2/]

Marad made a calculated decision when it granted its consent to the bareboat charter. It could easily have refused to consent to the Agreement to Charter, especially when it must have recognized USL's imminent bankruptcy. *See McLean*, 132 B.R. at 258-59. This decision, like many made in the "real world," was

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[2/] Marad relies primarily on *Bachner* v. *Robinson*, 107 F.2d 513 (2d Cir. 1939), in arguing that the Assignment did not diminish the Debtor's estate. Putting aside the precedential value of a case decided nearly 40 years prior to the Bankruptcy Code taking effect, *Bachner*, in fact, fails to support Marad's position. *Bachner* involved a lessor/creditor who refused to consent to an assignment of a lease prior to rent arrearages being paid. The assignee paid the arrearages *directly* to the lessor/creditor, and, as a result, consent to the assignment was given. In other words, the debtor or the general creditors never had a right to the rent arrearages. *Id.* at 514. In this case, the rent, i.e., the charter hire, did not belong to the creditor, i.e., Marad, until the assignment. Indeed, the "rent" belonged to the shipowner, i.e., USL. Thus, in *Bachner*, the transfer involved property that belonged to the creditor prior to the assignment. As a result, unlike this case, the estate in *Bachner* was not diminished.

risky. Unfortunately for Marad, its decision backfired when USL filed for bankruptcy protection. With this argument, Marad is asking me to undo a calculated decision that went awry. I am, however, unwilling to provide Marad with absolution for its poor decision. More importantly, the bankruptcy laws do not provide such. To so provide would give certain undersecured creditors an advantage over general creditors that Congress, by providing for avoidance of preferences, sought to preclude. *See Drabkin* v. *A.I. Credit Corp.*, 800 F.2d 1153, 1159 (D.C. Cir. 1986). Therefore, once the consent was granted, the Charters and the charter hire funds belonged to USL, and through the Assignment, the transfer of this property interest depleted the Debtor's estate.[19]

Marad also argues that the Debtor did not have control of the charter hire funds since the Depository Agreement required Chemical to hold the funds for Marad's account. Because of this lack of control, Marad contends that the earmark doctrine protects the Assignment from a preference claim. The earmark doctrine is a judicially created doctrine. *See Smyth* v. *Kaufman*, 114 F.2d 40, 42 (2d Cir. 1940). The cases applying the doctrine suggest that it

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[19] The Bankruptcy Court, in the alternative, ruled that the conditional right to bareboat charter was of value to the general creditors because the restrictive covenant only gave Marad a contractual claim if the covenant was breached, thereby leaving some liquidation value as set by the market. *McLean*, 132 B.R. at 260. Marad argues that the conditional right to bareboat charter was of no value because no evidence of a market for the bareboat charters absent its consent existed. The particular value of this conditional right is somewhat elusive; however, it seems farfetched to argue that this right was worth nothing because of the restrictive covenant. The covenant did not operate as a complete bar to bareboat chartering. It simply created a contractual remedy against USL if the covenant was breached. Thus, although it limited USL's options somewhat, the restrictive covenant did not render USL's right bareboat chartering [sic] the Vessels totally worthless. Thus, even if the property interest that was transferred was the right to bareboat charter, which it clearly was not, the transfer was still of value to the estate and its general creditors.

applies where: (1) the assets in question were never under the control of the debtor; (2) the assets are transferred from a third party to the creditor as a payment for an antecedent debt owed by the debtor; and (3) the debtor's estate is not diminished in value. *See generally*, 4 *Collier on Bankruptcy*, ¶ 547.03 (15th ed. 1993). *See also McCuskey* v. *National Bank of Waterloo* (*In re Bohlen Enterprises, Ltd.*), 859 F.2d 561, 564-67 (8th Cir. 1988); *Banque Paribas-London*, 797 F.2d at 1356.

The essence of the earmark doctrine is that a transfer should not be avoided where a third party transfers funds *directly* to a creditor and causes no diminution of the estate's assets. *Bohlen*, 859 F.2d at 566. The doctrine is usually applied where the third party is a new creditor who is "a guarantor for the debtor's obligation, such as a surety, a subsequent endorser or a straight contractual guarantor." *Id.* at 565. In other words, the earmark doctrine applies where the new creditor, in effect, is substituted for the original creditor. *See Banque Paribas-London*, 797 F.2d at 1356.

The Bankruptcy Court ruled that the Debtor had control of the assets in question. *McLean*, 132 B.R. at 261. Additionally, the Bankruptcy Court was troubled by the fact that this situation involved no new creditor as is usually the case when applying the earmark doctrine. *Id.*

Despite Marad's contention, the fact is that the Debtor was free to use the charter hire funds until: (1) it defaulted on the Insured Bonds, and (2) Marad enforced its rights under the Assignment. More importantly, the Debtor used these funds for its own purposes for some time after the Petition Date. If Marad had placed a hold on the funds prior to the Petition Date, perhaps it could legitimately argue that the Debtor had no control over the funds. *See Matter of Howdeshell of Fort Myers*, 55 B.R. 470, 474 (M.D. Fla. 1985). In this case, however, where the Debtor in fact possessed and used the charter hire funds, Marad's argument borders on frivolity. By contract and in fact, the Debtor had

control of the assets, and therefore the earmark doctrine does not apply.

Marad laments that the Bankruptcy Court did not cite a case that held that a new creditor must exist for the earmark doctrine to apply. Marad obviously missed the Bankruptcy Court's reference to *Bohlen*, 859 F.2d at 565. *McLean*, 132 B.R. at 261. In any event, the Bankruptcy Court did not hold that the earmark doctrine necessarily requires a new creditor in every instance. Instead, the court sensibly reasoned that as Lykes is not a creditor the earmark doctrine is inapplicable because "Lykes is not seeking to have Marad's debt satisfied and become a creditor of the Debtor's." *Id.* In other words, Lykes was not replacing Marad as a creditor. Without such a substitution, the earmark doctrine cannot be applied. *See Bohlen*, 859 F.2d at 565; *Banque Paribas-London*, 797 F.2d at 1356; *McGoldrick* v. *Juice Farms, Inc.* (*In re Ludford Fruit Products*), 99 B.R. 18, 21 (Bankr. C.D. Cal. 1989).

Although not explicit in the Bankruptcy Court's opinion, the earmark doctrine generally requires that a new creditor replace the original creditor in order to prevent the estate's assets from diminishing. *See, e.g., In re Trinity Plastics*, 138 B.R. 203, 208 (Bankr. S.D. Ohio 1992). If Lykes was a new creditor substituting Marad, then the estate's assets would likely have not diminished. As previously discussed, however, the transfer here led to a depletion of the Debtor's estate. For this reason alone, the earmark doctrine is inapplicable. *See Bohlen*, 859 F.2d at 565-66.

In the end, however, Lykes did not directly transfer the charter hire funds to Marad. The funds were first part of USL's estate and were used by USL for purposes other than paying its debts on the Insured Bonds. In such a circumstance, the earmark doctrine is not applicable. *See Portside Transport, Inc.* v. *Van Huffel Tube Corp.*, 127 B.R. 165, 166-67 (N.D. Ohio 1989). Therefore, the Bankruptcy Court correctly ruled that the earmark doctrine does not apply to this case.

Finally, Marad argues that the Assignment was simply an enforcement of a security interest it already had on the Vessels. As such, Marad contends that the Assignment was only a change in the form of the previously held rights, and consequently, the Assignment did not deplete the estate's assets. In fact, Marad had only a restrictive covenant requiring its consent prior to USL's bareboat chartering of the Vessels. A restrictive covenant is not a perfected security interest or a property interest that is valid against a debtor in possession or trustee under the Bankruptcy Code. *See Allegaert* v. *Chemical Bank*, 657 F.2d 495, 506 (2d Cir. 1980); *In re Allegheny Int'l, Inc.*, 93 B.R. 907, 909-10 (Bankr. W.D. Pa. 1988). *See also Kelly* v. *Central Hanover Bank & Trust Co.*, 11 F. Supp. 497, 507 (D.N.Y. 1935).

To argue that the restrictive covenant against bareboat chartering is a security interest in the charter hire and that the Assignment only changed the form of the arrangement is patently incorrect. *See In re Friese*, 28 B.R. 953, 955 (Bankr. D. Conn. 1983). The whole purpose behind the Assignment was to convert the restrictive covenant into a security interest. If the covenant was already a security interest, Marad would not have needed the Assignment.

Marad recognizes this and argues in the alternative that I should treat the restrictive covenant as being analogous to a security interest. I am, however, unwilling to do so. Restrictive covenants and security interests are different. They present different rights and obligations to parties. *See Allegaert*, 657 F.2d at 506. More importantly, these differences effect the financial terms of an agreement. The more security a creditor receives from the contractual terms of the debt it purchases, the less risky the debt becomes. It is axiomatic in finance that the pricing of a security, i.e., the rate of return demanded, is based primarily on the amount of risk the security carries. *See* Richard Brealey and Stewart Meyers, *The Principles of Corporate Finance*, 128-31 (2d ed. 1984). In essence, Marad is asking me to add retroactively security to the Insured Bonds without changing other bargained for

aspects of the debt, including price. A court's role, however, is to interpret the terms of a contract and not to rewrite them. *See Metropolitan Life Ins. Co.* v. *RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1519-22 (S.D.N.Y. 1989). Thus,

> [i]f a creditor wants security, let him take a security interest in some recognized form: mortgage, pledge, an Article 9 security interest or what not. If he wants protection against third parties, let him take possession of the collateral or file. Nothing is to be gained by giving a shadowy effectiveness to informal arrangements which conform to no recognized pattern. The debtor's covenant not to encumber property, like the contractor's covenant not to assign moneys to become due under his contract, should be treated, as on the whole the case law has done, as a covenant "merely personal"—good enough to give rights against the covenantor for breach, to bring an acceleration clause into play, to constitute an "event of default" under the loan agreement, but not good enough to give rights, whether they be called legal or equitable, in property.

Friese, 28 B.R. at 954 n.4, *quoting* 2 G. Gilmore, *Security Interests in Personal Property* § 38.3 at 1017 (1965).

Marad knows the difference between a restrictive covenant and security interest. It could have bargained for a security interest in any potential charter hire when it entered into the various mortgage and security agreements. It chose not to do so, and now it must live by its decision. Thus, the Bankruptcy Court correctly ruled that Marad's restrictive covenant was not a security interest in the Charters and the charter hire funds. Consequently, all three of Marad's arguments that contend that the transfer did not involve property of USL and did not diminish the estate's assets fail.

(b) The Hypothetical Chapter 7 Liquidation

The Bankruptcy Court ruled that Marad would have received less from a hypothetical Chapter 7 liquidation than it received from the Assignment. *McLean*, 132 B.R. at 262-63. The Court reasoned that Marad was an undersecured creditor. As such, the Assignment enhanced "its security cushion" so that it "became entitled to the charter hire in addition to its pre-existing security interests in the Vessels." *Id.* at 263. Marad contends that it received no more from the Assignment than it would have received in a hypothetical Chapter 7 liquidation proceeding.

Marad does not argue that it would have been entitled to the charter hire funds at the end of a hypothetical Chapter 7 liquidation. In fact, at the end of a Chapter 7 liquidation, Marad would have received less than it did from the Assignment plus its pre-existing security interests. Marad, however, argues that the Bankruptcy Court should have also considered events that possibly may occur after the hypothetical Chapter 7 liquidation. Marad contends that it would have received the Vessels in the Chapter 7 liquidation and then chartered them, perhaps even to Lykes. By chartering the Vessels, it would have received at least the value it received from the Assignment, *i.e.*, the charter hire. Therefore, it received no more from the Assignment than it would have eventually received from a Chapter 7 liquidation.

It is only necessary to read § 547(b)(5) of the Bankruptcy Code in order to dismiss Marad's arguments. The Code states: "the trustee may avoid any transfer...that enables [a] creditor to receive more than such a creditor would receive if...the case were a case under Chapter 7 of this title." 11 U.S.C. § 547(b)(5). The reference to the word "case" on two occasions reflects Congress' intent to compare the amount received as a result of a transfer to the amount a liquidation proceeding would yield. *See* House Report at 6328 (emphasizing that the new version of § 547(b) requires a recreation of a Chapter 7 proceeding, including all its procedural complexities, rather than a general liquidation

proceeding). *See also* Vern Countryman, *The Concept of Voidable Preference in Bankruptcy*, 38 Vand. L. Rev. 713, 740-41 (1985) ("The logic of Section 547(b)...indicates that the valuation of the collateral be made *at the time of* the Chapter 7 distribution") (emphasis added). Any value a creditor could create from what it received from a liquidation is not to be considered and is irrelevant. *See id.*; *Braniff Airways, Inc.* v. *Exxon Co., U.S.A.* 814 F.2d 1030, 1034 (5th Cir. 1987). *See also Marathan Oil Co.* v. *Flatau (In re Craig Oil Co.)*, 785 F.2d 1563, 1566 (11th Cir. 1986) (creditor's state of mind is immaterial in determining the amount the creditor would have received in a hypothetical Chapter 7 proceeding).

Further, as a matter of policy, a court should avoid speculation as to what a creditor may or may not do after a liquidation proceeding. It would be fallacious for a court to pretend that it could value a potential use of liquidation proceeds based only on a creditor's vague hopes or possibilities. For example, a creditor could use liquidation proceeds to purchase a risk free security, *i.e.*, government issued bonds. Considering the interest a creditor may earn from any post-liquidation investment, however, would circumvent the purpose behind § 547(b) because eventually all liquidation proceeds will increase in value so as to be equal to the amount transferred. Yet, this is precisely what Marad is asking me to do. I will not make such a determination.

Thus, the Bankruptcy Court was correct in considering only what the hypothetical liquidation proceeding would have yielded and not what potential gain Marad may have extracted from the Vessels. The undisputed fact is that Marad was undersecured. Because of the Assignment, Marad received a security interest in the charter hire in addition to what it was entitled to in the hypothetical Chapter 7 liquidation. Consequently, Marad would have received less from a Chapter 7 liquidation proceeding that it did from the transfer. Therefore, The [sic] Bankruptcy Court correctly ruled the Assignment satisfies the fifth element of the § 547(b) requirement.

(3) Exceptions to Voidable Preferences

Marad argues that both the "new value" and/or the "improvement in position" exceptions apply to these facts so as to make the Assignment non-voidable. The Bankruptcy Court ruled that neither exception applied to these facts, and for the following reasons, this ruling is affirmed.

(a) New Value

Section 547(c)(1) of the Bankruptcy Code protects a transfer from avoidance if the transfer was "intended by the debtor and creditor...to be a contemporaneous exchange for new value given to the debtor" and was "in fact a substantially contemporaneous exchange." 11 U.S.C. § 547(c)(1). The Code, in turn, defines "new value" as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including process of such property, but does not include an obligation substituted for an existing obligation." 11 U.S.C. § 547(a)(2).

Marad argues that by granting its consent to the bareboat charter it exchanged new value to USL. In particular, Marad describes its consent as a "release...of property." *Id.* Marad, however, had no "property" in the bareboat charters prior to the Assignment. A mortgage under the Ship Mortgage Act does not extend to the freight of the mortgaged vessel absent express language in the mortgage documents. *In re Levy-Mellon*, 61 B.R. 331, 334 (Bankr. W.D. La. 1986). *See also United States* v. *Sterling*, 22 F.2d 323, 325 (D.N.Y. 1927). A vessel's earnings, including charter hire, is part of a vessel's freight. *Levy-Mellon*, 61 B.R. at 334.

Thus, to have a property interest in the charter hire prior to the Assignment, the mortgage documents would have to

expressly provide that Marad has a security interest in the Vessel's freight. No such provision, however, exists in any of the mortgage documents. Consequently, Marad did not have an express property right to the charter hire at the time the Mortgages were executed. It gained this right only through the Assignment. Additionally, as previously discussed, Marad did not have a security interest in the charter hire prior to the Assignment. Therefore, Marad had no "property" it could release or transfer so as to create "new value" when it consented to the Agreement to Charter.

Marad also argues that the term "new value" is synonymous with the contractual notion of consideration. In other words, anything that would be considered valid consideration in forming a contract is also new value for § 547(b) purposes. Moreover, Marad argues that its consent constitutes valid consideration and therefore meets the definition of new value. The granting of the consent was a decision to forebear on a legal right, i.e., the right to sue if USL entered into a bareboat charter without Marad's consent. Forbearance is, of course, valid consideration for determining whether a contract exists. *See In re Duffy*, 3 B.R. 263, 266 (Bankr. S.D.N.Y. 1980). Forbearance, however, does not constitute new value as defined by the bankruptcy code. *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 298 (11th Cir.), *cert. denied*, 488 U.S. 993, 109 S. Ct. 557, 102 L. Ed. 2d 584 (1988); *Drabkin*, 800 F.2d at 1159; *Matter of Mid Atlantic Fund, Inc.*, 60 B.R. 604, 609 (Bankr. S.D.N.Y.); *Duffy*, 3 B.R. at 266.

This is particularly clear from the fact that the Bankruptcy Code specifically excludes from the definition of new value the substitution of obligations. 11 U.S.C. § 547(a)(2). The entire transaction here involved Marad substituting one obligation (the mortgages' requirement to obtain Marad's consent) for another (Marad's rights under the Assignment). As such, the Bankruptcy Code excludes Marad's forbearance from the definition of new value. Indeed, any other rule would grant an undersecured creditor more bargaining power and, therefore, an advantage over other general creditors in contravention of the goals of the Bankruptcy

Code. *Drabkin*, 800 F.2d at 1159; *Chase Manhattan Bank, N.A.* v. *Dent (In re Trans Air, Inc.)*, 78 B.R. 351, 384 (Bankr. S.D. Fla. 1987). Thus, Marad's consent to the Agreement to Charter does not amount to "new value" as defined by the Bankruptcy Code.[11/]

(b) **The Improvement in Position Test**

Section 547(c)(5) codifies the so-called "improvement in position test." 11 U.S.C. § 547(c)(5). The provision is aimed at secured creditors holding a 'floating lien' on a debtor's inventory and receivables. *See generally 4 Collier on Bankruptcy* § 547.13 (15th ed. 1993). It permits a creditor with a perfected security interest on "receivables" of a debtor to maintain that lien as the specific accounts are repaid and replaced by new accounts without fear that a bankruptcy trustee will initiate a preference avoidance action on new receivables arising during the "preference" period. *See Braunstein* v. *Karger (In re Melon Produce, Inc.)*, 976 F.2d 71, 75 (1st Cir. 1992). This exception protects new receivables from preference challenges, however, only to the extent they substitute old ones. A grant of a security interest that improves a creditor's position is not protected. *Id.*

More importantly, § 547(c)(5) presupposes that the lien on receivables be perfected prior to the preference period. *See Markie* v. *Phillips*, 24 B.R. 712, 714 (Bankr. E.D. Cal. 1982). *See also Financial Center Assoc. of East Meadow L.P.* v. *TNE Funding Corp. (In re Financial Center Assoc. of East Meadow, L.P.)*, 140 B.R. 829, 832-33 (Bankr. E.D.N.Y. 1992). Through the

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11/ Marad also suggests that it exchanged new value when it entered into a new ODS contract with Lykes concurrently with the Charters and the Assignment, thereby making the USL/Lykes arrangement more economically viable. Section 547(c)(1) expressly requires "new value [be] given to the debtor." 11 U.S.C. § 547(c)(1). The ODS contracts may have given Lykes new value, but they failed to give USL new value, as the term is defined by the Bankruptcy Code.

Assignment, Marad had a perfected security interest in the Charters on November 4, 1986. This is clearly after the preference period which began ninety days prior to the Petition Date, or August 24, 1986. 11 U.S.C. § 547(c)(5)(A)(i). Thus, since Marad did not have a perfected security interest prior to this date, the § 547(c)(5) exception is not applicable.

Even if the timing of the perfection occurred prior to the preference period, Marad clearly improved its position through the Assignment. As discussed previously, the Assignment was more than a mere change in the form of the rights already existing. Through the Assignment, Marad's security increased, and as such, this exception is not applicable.

(4) Ratification

Marad argues that by assuming the Charters, the Debtor assumed the burden of the charter hire payment along with the various benefits of the Charters. As such, Marad contends that the Debtor ratified the Assignment and that it is now bound by this determination, effectively "barring" the Debtor's claim to avoid the Assignment.[12/]

12/ In a footnote in its reply memorandum of law, Marad raises the possibility that the Plan's confirmation may have had a res judicata effect, thereby barring the adversary proceeding initiated by the Debtor. *See Sure Snap Corp.* v. *State Street Bank & Trust Co.*, 948 F.2d 869, 876-77 (2d Cir. 1991). Res judicata, however, is not a jurisdictional bar to repetitive litigation, and it can be waived. *See New York Shipping Ass'n* v. *Federal Maritime Commission*, 854 F.2d 1338, 1352 (D.C. Cir. 1988), *cert. denied*, 488 U.S. 1041, 109 S. Ct. 866, 102 L. Ed. 2d 990 (1989). Marad never raised this defense during the Bankruptcy Court's adversary proceeding or its initial memorandum of law for that matter. Consequently, the res judicata defense was waived. Any discussion of res judicata here would, therefore, be purely academic.

The Bankruptcy Court ruled that the Charters and the Assignment are two separate agreements. Consequently, it held that the assumption of the Charters did not constitute an assumption or ratification of the Assignment. *McLean*, 132 B.R. at 265. Marad argues that the Bankruptcy Court should have ruled that the Charters and the Assignment were one agreement pursuant to the principle of *cum onere*.

As a general matter, once an executory contract is assumed, it is assumed *cum onere*—with all of its benefits and burdens. *See NLRB* v. *Bildisco & Bildisco*, 465 U.S. 513, 531, 104 S. Ct. 1188, 1198, 79 L. Ed. 2d 482 (1984). USL assumed the Charters pursuant to the Plan. The Charters expressly provide that the charter hire funds be paid to a financial institution designated by Marad pursuant to the Assignment. It is undeniable that once the Debtor assumed the Charters it assumed its benefits along with its burdens. The issue is whether the Assignment was one of its burdens.

The Assignment was incorporated into the Charters. This incorporation, by itself, however, does not necessarily mean that the Assignment became one of the burdens of the Charter. The *cum onere* principle does not provide that once a contract is assumed, every single provision of that contract is enforceable by and against a debtor. *See Rockland Center Assoc.* v. *TSW Stores of Nanuet (In re TSW Stores of Nanuet, Inc.)*, 34 B.R. 299, 304 (Bankr. S.D.N.Y. 1983). Here, the Assignment is not the basis of the Charters. In fact, Marad was not even a signatory to the Charters. Lykes and USL were the only parties that exchanged "benefits and burdens" through the Charters. Indeed, the burden that Marad argues to have been assumed by the Debtor runs only for the benefit of Marad. Lykes had no interest as to which party received the charter hire as long as it could charter the Vessels. Thus, by assuming the Charters, the Debtor did not assume the burden of losing the charter hire Lykes was paying.

Moreover, application of the *cum onere* principle is subject to statutory change. The Bankruptcy Code, itself, alters the rights of the parties. *See id.* In this case, Congress has provided for the avoidance of preferential transfers. 11 U.S.C. § 547(b). Where the application of the *cum onere* principle will frustrate the intent of Congress, it is not applicable. As the Bankruptcy Court ruled:

> A voidable preferential transfer will not be otherwise cleansed of its preferential taint by somehow being cleverly tied into a separate valid and unavoidable transfer or agreement. If this were true, any clever creditor could be preferred, in direct violation of the Code, but be removed from the debtor's avoidance powers by tying it to a separate valid transaction.

McLean, 132 B.R. at 265. Thus, even if the *cum onere* principle were to require the Debtor to assume the "burdens" of the Assignment, which it does not, it is not applicable here because § 547(b) trumps its application. It would simply frustrate Congress' intent behind enacting § 547(b) to hold otherwise.

(5) Estoppel

Marad argues that the Debtor should be estopped from raising this claim for avoidance of the Assignment because it represented in the Stipulation and the Disclosure Statement that it would not seek such a remedy. The Bankruptcy Court declined to apply this equitable doctrine because it found that the Debtor's acts were not egregious or dishonest so as to require equitable intervention. *McLean*, 132 B.R. at 267.

For equitable or promissory estoppel to apply, the conduct of the party against which the claim is asserted must as a threshold matter "amount[ ] to false representations or concealment of material facts which gives the impression that the facts are otherwise than asserted." *Eastern Sys.* v. *West 45th Street Condominium, Inc.*, 105 B.R. 219, 234 (Bankr. S.D.N.Y. 1989),

aff'd, 1991 WL 90733, 1991 U.S. Dist. LEXIS 6935 (S.D.N.Y. May 23, 1991). Neither the Stipulation nor the Disclosure Statement misleads Marad as to whether the Debtor would seek the avoidance of the Assignment.

The Stipulation did not address the issue of preference avoidance. It simply did not state that the Debtor would not pursue a preference avoidance claim. The fact that the Debtor was willing to let Marad have the charter hire funds is not a waiver of the right to pursue a claim later that the Assignment was an impermissible transfer of assets. Without an explicit waiver, Marad's decision to rely on the Stipulation and not seek potential legal remedies was simply a strategic decision. More importantly, the Stipulation required court approval. It never received such approval and therefore is not enforceable. *See Tavormina* v. *Fir, Inc. (In re Alchar Hardware Co., Inc.)*, 764 F.2d 1530, 1534-35 (11th Cir. 1985).

In the Disclosure Statement, the Debtor specifically stated that it "has reserved the right to assert any [avoidance] claims should the Debtor[ ] become aware of their existence. Any such claims shall become the property of...the USL Reorganization Trust,...." Marad's decision to rely on the Disclosure Statement as some sort of waiver despite this language was again simply a strategic decision. This language clearly establishes that the Debtor did not mislead Marad as to its intentions. Thus, the Debtor did not misrepresent or conceal any facts to Marad so as to estop them from asserting a preference claim. *See Eastern Sys.*, 105 B.R. at 234. Consequently, the Bankruptcy Court correctly ruled that equitable and/or promissory estoppel was not applicable to this case.

CONCLUSION

For the foregoing reasons, the decision of the Bankruptcy Court, Cornelius Blackshear, J., is hereby affirmed in its entirety.

SO ORDERED.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	
McLEAN INDUSTRIES, INC., et al.,	:	
Debtors.	:	
		91 Civil 7543
UNITED STATES LINES (S.A.), INC.,	:	(KTD)
Plaintiff-Appellee,	:	JUDGMENT
-against-	:	
UNITED STATES OF AMERICA,	:	
Defendant-Appellant.	:	

Appellant, The United States of America on behalf of the Maritime Administration ("Marad"), Department of Transportation, having appealed to this court, pursuant to 28 U.S.C. Section 158(a), from an Order of the United States Bankruptcy Court for the Southern District of New York, Cornelius Blackshear, J., granting the USL Reorganization Trust's, successor in interest to United States Lines (S.A.), Inc., Motion for Summary Judgment and denying Marad's Motion for Summary Judgment, and the said appeal having come before the Honorable KEVIN THOMAS DUFFY, United States District Judge, and the Court thereafter on December 21, 1993, having handed down its memorandum and order; affirming in its entirety the decision of the Bankruptcy Court, Cornelius Blackshear, J., it is,

ORDERED, ADJUDGED AND DECREED: That the decision of the United States Bankruptcy Court for the Southern District of New York, Cornelius Blackshear, J., be and it is hereby affirmed in its entirety for the reasons stated in the Court's Memorandum and Order, dated December 21, 1993, and it is further,

ORDERED, that the action be and it is hereby dismissed.

DATED: New York, New York
December 29, 1993

/s/ James M. Parkison
Clerk

By: /s/ Ronald A. Chinel
Deputy Clerk

In re McLean Industries, Inc.,
et al., Debtor.

United States Lines
(S.A.), Inc., Plaintiff,
v.
The United States of America and
Chemical Bank, it is capacity as
depository, Defendants.

Bankruptcy Nos. 86-B-12238 (CB)
to 86-B-12241 (CB).
Adv. No. 89-6125A.

United States Bankruptcy Court,
S.D. New York

Sept. 11, 1991.
As corrected Sept. 17, 1991.

Chapter 11 debtor vessel owner brought preference proceeding to avoid assignment and depository agreement which gave the Maritime Administration security interest in charter hires for debtor's vessels. The Bankruptcy Court, Cornelius Blackshear, J., held that: (1) the Maritime Administration waived defense of sovereign immunity by filing proof of claim and seeking to set off its debt against amount held in depository account under the assignment and depository agreement; (2) debtor was insolvent at time assignment and depository agreement were executed; (3) transfer represented by the assignment and depository agreement involved property of the estate; and (4) the Maritime Administration failed to establish that assignment and depository agreement came within the new value exception to the debtor's avoiding power.

So ordered.

Milbank, Tweed, Hadley & McCloy by Robert Drain, New York City, for debtor.

Civ. Div., Dept. of Justice, Washington, D.C. by John T. Stemplewicz.

DECISION ON MOTION AND CROSS-MOTION FOR SUMMARY JUDGMENT PERTAINING TO AN ALLEGED PREFERENTIAL TRANSFER.

CORNELIUS BLACKSHEAR,
Bankruptcy Judge.

The plaintiff, United States Lines (S.A.), Inc. (the "Debtor" or "SA"), one of the debtors and debtors in possession, filed a motion for summary judgment and one of the defendants, the United States of America, on behalf of the Maritime Administration ("MARAD"), has cross-moved for summary judgment. The basis of this adversary is an alleged preferential transfer made by SA to MARAD.

The following are the uncontroverted facts:

The vessels, S.S. AMERICAN ARGO ("ARGO"), S.S. AMERICAN RIGEL ("RIGEL"), and S.S. AMERICAN VEGA ("VEGA"), (the "Vessel" or "Vessels"), were built in 1964 and 1965 for Moore-McCormack Liners, Inc. ("Moore-McCormack") and were then known as S.S. MORMACARGO, S.S. MORMACRIGEL and S.S. MORMACVEGA. Construction was financed in large part by United States government programs administered by MARAD. MARAD paid $15 million in construction-differential subsidy ("CDS") pursuant to a contract with Moore-McCormack, dated June 29, 1962, (the "1962 CDS Contract"). Additionally, Moore-McCormack issued bonds totaling $11,526,000 due April 1, 1987, secured by a first preferred ship mortgage on each Vessel, dated June 7, 1967 (the "1967 Ship

Mortgage"), insured by MARAD under title XI of the Merchant Marine Act, 1936, as amended, 46 U.S.C. app. §§ 1271 *et seq.* ("Title XI").

Moore-McCormack operated the Vessels between ports along the Atlantic coast of the United States and South Africa and the east coast of South America. The Vessels qualified for and received operating-differential subsidy ("ODS") from MARAD under contracts covering the above trade routes and authorized by Title VI of the Merchant Marine Act, 1936, as amended, 46 U.S.C. app. §§ 1171 *et seq.*

Beginning in 1981, the Vessels underwent extensive modifications, converting them from cargo to cargo/container ships by, among other things, adding a 115-foot midbody section to each Vessel. Reconstruction of the ARGO, RIGEL and VEGA cost approximately $54 million (not including the cost of a fourth vessel, the AMERICAN RESERVIST ("RESERVIST")), of which approximately $22.6 million came from another CDS contract (the "1981 CDS Contract"). Moore-McCormack also borrowed $34,300,000 (of which, approximately $25.7 million was allocated to the ARGO, RIGEL and RESERVIST) through the Title XI bonds guaranteed by MARAD. The new Title XI bonds were secured by a second preferred fleet mortgage dated January 27, 1983 (the "1983 Fleet Mortgage").

Moore-McCormack also entered into certain tax benefit transactions (the "TBT Leases") to sell the tax benefits associated with reconstruction of ARGO and VEGA. The tax benefits relating to the TBT Leases, which Moore-McCormack sold for $6,210,000, decline over time through 1994. The TBT Leases were backed by letters of credit providing full indemnification should any of the tax benefits be terminated by mortgage foreclosure.

In early 1983, Moore-McCormack was acquired by McLean Securities, Inc., the parent of United States Lines, Inc.

("USL") and was renamed United States Lines (S.A.), Inc. In connection with the purchase, Chemical Bank ("Chemical") loaned SA $50 million secured partially by a preferred fleet mortgage on the vessels that SA acquired. Chemical's fleet mortgage was subordinate to the 1967 Ship Mortgage and the 1983 Fleet Mortgage.

In 1986, as part of a widely publicized debt restructuring plan necessitated by huge operating losses, SA asked MARAD and the Title XI bondholders to defer the $2,450,000 principal payment due June 30, 1986, on the 1983 Fleet Mortgage. MARAD and the bondholders agreed to defer the June 30, 1986 payment to June 30, 1988. In return, SA agreed to amend the security agreement under the 1983 Fleet Mortgage to include certain additional security defaults (the "Amended Security Agreement"). This was accomplished on July 31, 1986.

The Amended Security Agreement contained a covenant against bareboat chartering the Vessels without MARAD's consent. The same restrictive covenant was contained in the 1967 Ship Mortgage, the 1981 CDS Contract, SA's ODS Contract, and the Title XI Reserve Fund and Financial Agreement entered into concurrently with the 1983 Fleet Mortgage. None of these agreements in any way restrict MARAD's power to consent to any bareboat charter of the Vessels.

On August 15, 1986, SA applied for MARAD's consent to proposed bareboat charters of the ARGO, RIGEL and VEGA to Lykes Bros. Steamship Company ("Lykes"). SA had not employed any of the Vessels in its own operations since December 1985. Lykes had agreed in principle to charter the Vessels, subject to MARAD's consent, for use on certain trade routes to be designated by Lykes in its own application.

On September 24, 1986, SA and Lykes signed a formal agreement ("Agreement to Charter") providing for a three-year bareboat charter of the Vessels and granting Lykes an option to

purchase. The Agreement to Charter was conditioned expressly upon MARAD's consent to SA chartering the Vessels to Lykes as required by SA's ODS contract, the 1967 Ship Mortgage and the 1983 Fleet Mortgage and MARAD's consent to Lykes chartering the Vessels from SA as required by Lykes' ODS contract. The Agreement to Charter also was conditioned expressly upon MARAD agreeing to amend Lykes' ODS contract so that Lykes could operate the Vessels on a subsidized basis between ports along the Atlantic coast of the United States and the west coast of South America.

On October 16, 1986, MARAD agreed to consent to the charters and to amend Lykes' ODS contract subject to certain conditions. Among other things, MARAD required an assignment of the charters as additional security for its mortgages on the Vessels.

Neither SA nor Lykes objected to MARAD's conditions, but, if the conditions had not been met, MARAD would not have consented to the charters or agreed to amend Lykes' ODS contract.

On November 4, 1986, the parties entered into a series of agreements: (1) three bareboat charter parties (the "Charters") between SA and Lykes; (2) a Charter Assignment and Agreement among SA, Lykes and MARAD (the "Assignment"); (3) a Depository Agreement between MARAD and Chemical (the "Depository Agreement"); and (4) an Agreement between MARAD and Lykes ("MARAD/Lykes Agreement") acknowledging MARAD's mortgages and its interest in the Charters and including covenants of quiet enjoyment.

The Charters were for three-year periods; however, they could be terminated at the end of the first year at Lykes' option.

The Charters made the following provision for payment of charter hire:

> Charter hire...shall be paid...to Chemical Bank or such other U.S. financial institution as shall from time to time be designated in writing by the United States of America represented by the Secretary of Transportation acting by and through the Maritime Administration (hereinafter the "Secretary"), for credit to the account of the Secretary pursuant to an assignment of this Charter and Charter Hire hereunder to the Secretary from Owner dated the date hereof.

The Assignment provided in relevant part, as follows:

> 1.1 The Shipowner hereby assigns, transfers and sets over, and does hereby assign, transfer and set over unto Marad, its successors and assigns, all the right, title and interest of the Shipowner in and to those each of the Charters ("Marad's Security Interest") as security for the Shipowner's performance of its obligations under the Mortgages and in consideration of Marad's consent to the Charters.
>
> 1.2 It is expressly agreed that anything herein contained to the contrary notwithstanding: (i) the Shipowner hereby irrevocably instructs the Charterer, pursuant to the terms of the Charters and for the account of Marad, to make all payments of Charter Hire and other amounts payable under or pursuant to the Charters directly to the Depository Account (as defined in the Depository Agreement, which is itself defined hereinafter), or such other account as Marad may notify the Charterer and the Shipowner of in writing, until the Charterer receives a written notice from Marad that all Title XI obligations under the Mortgages have been paid in full or otherwise released; (ii) the Shipowner shall remain liable under the Charters to perform all the obligations assumed by it thereunder; and (iii) Marad shall have no obligation or liability under the Charters by reason of, or arising out of,

this Agreement and shall not be obligated to perform any of the obligations of the Shipowner under the Charters.

* * * * * * * * * *

3.2 The Charterer agrees that the Charters and all of the terms, covenants and provisions thereof and all rights, remedies and options of Charterer thereunder (other than its rights to terminate the Charters in accordance with the express terms of the Charters and its right in personam against the Shipowner) shall be and shall at all times continue to be subject and subordinate in all respects to each of the Mortgages and to the respective liens thereof.

Under the Depository Agreement, Chemical agreed to receive the charter hire. Chemical was to transfer to SA any charter hire paid by Lykes no later than one business day after the funds became available, unless MARAD notified Chemical of a demand upon MARAD's Title XI guarantees on the Vessel. After receiving notice of a demand upon MARAD's guarantees, Chemical was to hold charter hire payments subject to MARAD's instructions.

The MARAD/Lykes Agreement provided, *inter alia*, that MARAD could exercise any of its rights as mortgagee in the event of default under the mortgages, but that MARAD would do so with a minimum disruption to Lykes. The Charters were subordinate to MARAD's mortgages.

As mortgagee, MARAD had the right upon default to take possession of and "hold, lay up, lease, charter, operate, or otherwise use" the Vessels.

On November 24, 1986, ("Petition Date"), SA filed its voluntary petition under chapter 11 of Title 11, United States Bankruptcy Code (the "Code"). SA continued to operate its

business as a debtor-in-possession in accordance with § 1107 of the Code.

SA made no payment on its Title XI debt after the Petition Date. Its last Title XI payment was the July 1, 1986 semiannual payment, in the principal amount of $292,000, on the 1967 Ship Mortgage. On February 26, 1987, MARAD received the first demand upon its Title XI guarantees on the Vessels. Pursuant to the Depository Agreement, MARAD instructed Chemical to hold for MARAD's account all charter hire deposited by Lykes.

Chemical stopped transferring charter hire deposits to SA but refused, when requested, to transfer the deposits directly to MARAD without a court order.

After discussions between SA and MARAD, SA acknowledged that MARAD should receive all charter hire that Lykes paid after MARAD received the demand on its guarantees, including charter hire paid before MARAD notified Chemical of the Title XI demand pursuant to the Depository Agreement.

MARAD and SA signed a Stipulation and Order Providing for Repayment of charter hire (the "Charter Hire Stipulation" or "Stipulation") requiring Chemical to disburse all Lykes charter hire as MARAD may direct and providing that SA would pay MARAD $126,000 for charter hire transferred to SA after MARAD received the Title XI demand but before MARAD notified Chemical of that demand.

The Stipulation was conditioned only upon court approval, and the parties set no time limit for obtaining the requisite court approval.

At the June 25, 1987 hearing to approve the Charter Hire Stipulation, the only objecting party was Chemical, which, as a creditor of SA, argued that SA could set off the charter hire

against ODS payments due SA from MARAD. The hearing was adjourned pending further resolution of Chemical's objection.

MARAD and Chemical tried to negotiate a settlement of Chemical's objection to the Stipulation. An issue of some importance to Chemical was MARAD's cooperation in a sale of the ARGO that would leave unaffected the TBT Leases and the letters of credit issued by Chemical in favor of the holders of the TBT leases. Such a sale was unlikely to occur before late 1989, upon expiration of the Charters. At MARAD's request, Chemical agreed to pay interest on the depository account while the matter was pending.

On October 9, 1987, Lykes requested that MARAD extend the subsidizable life of the Vessels beyond the statutory 25-year limitation. Lykes would not make additional investments in the Vessels if they would be unavailable for Lykes' subsidized routes for a sufficient time to justify the expenditures. Lykes' option to terminate the Charters at the end of the first year was extended pending MARAD's decision. On December 7, 1987, MARAD agreed to extend the subsidizable life of each Vessel for three years. Lykes did not exercise its option to terminate the Charters.

During the term of the Charters, MARAD paid Lykes approximately $36.5 million in ODS in connection with Lykes' operation of the Vessels.

On December 31, 1987, MARAD filed a proof of claim for amounts due on the 1967 Ship Mortgage and the 1983 Fleet Mortgage. The proof of claim included the approximately $2.4 million that Chemical held in the depository account. SA never contested the validity, priority or amount of MARAD's mortgages on the Vessels.

The 1967 Ship Mortgage and the 1983 Fleet Mortgage were valid and perfected preferred mortgages under the Ship Mortgage Act, 1920. SA had no equity in the Vessels.

On March 23, 1989, SA's Second Amended and Restated Disclosure Statement ("Disclosure Statement") was approved.[1/] On May 16, 1989, SA's First Amended and Restated Joint Plan of Reorganization ("Plan") was confirmed.

In conjunction with the plan, SA unqualifiedly assumed the Charters, which still required payment of the charter hire to Chemical.

MARAD did not object to confirmation of the Plan or to assumption of the Charters.

In August 1989, SA informed MARAD that it intended to seek recovery of the charter hire on the theory of a voidable preference and/or fraudulent conveyance.

After the Charters expired, the Vessels were sold to Lykes pursuant to a court order dated December 13, 1989. The sale was structured to keep the TBT Leases in place and prevent drawdown of the letters of credit securing SA's guarantees of the tax benefits. Lykes gave MARAD a $9.3 million note to purchase the Vessels, and SA remained liable for any deficiency under the 1967 Ship Mortgage and the 1983 Fleet Mortgage.

MARAD's Title XI deficiency on the Vessels, as of April 30, 1990, was $10,972,201.60.

The balance in the Lykes charter hire depository account at Chemical, as of April 30, 1990, was $9,717,328.22.

[1/] This case was originally assigned to the Honorable Howard C. Buschman, III and subsequently transferred to this Court.

DISCUSSION

A. Sovereign Immunity

An action under 11 U.S.C. § 547(b) to recover an alleged preferential transfer from a governmental unit requires a waiver of sovereign immunity. *Hoffman* v. *Connecticut Dept. of Income Maintenance (In re Willington Convalescent Home, Inc.)*, 850 F.2d 50, 55 (2d Cir. 1988), *aff'd*, 492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76 (1989). In section 106(a) of the Code, Congress provided a limited waiver of sovereign immunity pursuant to which, unless satisfied, governments still enjoy immunity from suit:

> A governmental unit is deemed to have waived sovereign immunity with respect to any claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which such governmental unit's claim arose.

11 U.S.C. § 106(a).

In the instant case, the parties agree that sovereign immunity is waived when the following three requirements are satisfied: (1) the claim against the governmental unit is property of the estate; (2) the governmental unit filed a claim against the estate; and (3) the claim against the governmental unit arises out of the same transaction or occurrence from which the governmental unit's claim arises. *In re Malmart Mort. Co.*, 109 B.R. 1, 3 (Bankr. D. Mass. 1989). *See also In re Prudential Lines Inc.*, 79 B.R. 167, 180-81 (Bankr. S.D.N.Y. 1987.)

The standard found in § 106(a) mirrors the compulsory counterclaim rule found in Rule 13 of the Federal Rules of Civil Procedure,[2/] which provides in part as follows:

> (a) Compulsory Counterclaims. A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction.

Fed. R. Civ. P. 13(a).

In determining whether a claim and opposing claim arise out of the same "transaction or occurrence," the Second Circuit requires a finding of a "logical relationship" between the claims. *United States* v. *Aquavella*, 615 F.2d 12, 22 (2d Cir. 1979); *United Artists Corp.* v. *Masterpiece Productions, Inc.*, 221 F.2d 213, 216 (2d Cir. 1955). The logical relationship test used by the Second Circuit reflects the Circuit's broad and flexible interpretation of the compulsory counterclaim rule. *United States* v. *Aquavella*, 615 F.2d at 22. This Circuit clearly does not require an "absolute identity of factual backgrounds." *Id.*

The logical relationship test requires a finding that "the essential facts of the various claims are so logically connected that considerations of judicial economy and fairness dictate that all the issues be resolved in one lawsuit." *Harris* v. *Steinem*, 571 F.2d 119, 123 (2d Cir. 1978). Another court stated that the logical relationship standard calls for a showing that the opposing claim

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[2/] The legislative history of § 106(a) indicates that it applies to compulsory counterclaims as defined in the Federal Rules of Civil Procedure. S. Rep. No. 989, 95th Cong., 2d Sess. 29-30 (1978) *reprinted in* 1978 U.S. Code Cong. & Admin. News, 5787, 5815-16.

arises from the same aggregate of operative facts as the initial claim. *In re Lile*, 96 B.R. 81, 85 (Bankr. S.D. Texas 1989).

In the instant case, SA's claim against MARAD falls within the definition of a compulsory counterclaim. Both MARAD's claim and the Debtor's preference claim assert rights to the same matter: the charter hire. MARAD indirectly asserts its right, under the Assignment and the Depository Agreement, to obtain the deposited charter hire (and the right to set off funds in the depository account against MARAD's mortgage debt), while the Debtor seeks to avoid the Assignment and the Depository Agreement as preferential transfers to MARAD and asserts its right to recover the same funds. MARAD's proof of claim (No. 11222) against the Debtor, not only asserts that the Debtor owes MARAD $20,891,618.55 pursuant to the Title XI Guarantees and Preferred Mortgage, but MARAD also seeks to set off its debt against the $2,353,933.10 then held by Chemical in the depository account under the Assignment and the Depository Agreement.

MARAD posits that it did not waive governmental immunity because its claims "relate only indirectly to the Assignment, which is the alleged preference and/or fraudulent conveyance, in that the Assignment was additional security for the mortgages." United States Memorandum in Support at 20.

Congress intended to prevent a governmental unit from receiving a "distribution from the estate without subjecting itself to any liability it has to the estate arising from the same transaction or occurrence upon which its distribution is based." *In re Prudential Lines, Inc.*, 79 B.R. at 180; *see also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 317 (1972); S. Rep. No. 989, 95th Cong., 2nd Sess. 29-30 (1978). The instant scenario is just the sort which Congress sought to avoid. The claims at issue before this Court are so integrally related that the opposing claim must be deemed to be a compulsory counterclaim in light of the stated test and in the interests of judicial economy.

MARAD objects to the characterization of the opposing claim as a compulsory counterclaim insomuch as MARAD's claims are based on the 1967 Ship and the 1983 Fleet Mortgage and SA's opposing claim arises from the Assignment and Depository Agreement. MARAD seeks to focus only on the fact that the mortgages are separate from, albeit related to, the Assignment and Depository Agreement. Granted, if the claims at issue arose from the same agreement, undeniably, the claims would satisfy the logical relationship test. But the logical relationship test does not require that the claims arise from the same agreement. In the instant case, MARAD included in its proof of claim a setoff representing the money in the depository account as of a date certain. In doing so, MARAD itself recognized the integral relation between its claim on the mortgages and its claim pursuant to the Assignment and Depository Agreement.

B. **Timeliness of this Adversary Proceeding**

Section 546(a) of the Code provides that avoidance actions may not be commenced after the earlier of:

(1) two years after the appointment of a trustee...; or

(2) the time the case is closed or dismissed.

11 U.S.C. § 546(a)(1). The Debtor had until the close of this case to commence this adversary proceeding. *Korvettes, Inc.* v. *Sanyo Electric, Inc. (In re Korvettes, Inc.)*, 67 B.R. 730, 734 (S.D.N.Y. 1986); *Caplan* v. *U.S. Brass & Copper Co. (In re Century Brass Products, Inc.)*, 127 B.R. 720 (Bankr. D. Conn. 1991) (citing *In re Korvettes* as the law of the second circuit); *contra Zilkha Energy Co.* v. *Leighton*, 920 F.2d 1520 (10th Cir. 1990) (holding that § 546(a)(1) is ambiguous and that Congress intended the two-year limitation applying to appointed trustees to apply as well to their functional equivalents - debtors-in-possession). Since this case is still open, this preference action is certainly timely.

C. **Summary Judgment**

Rule 56(c) of the Federal Rules of Civil Procedure, made applicable to bankruptcy adversary proceedings by Bankruptcy Rule 7056, provides that summary judgment should be granted "if the pleadings, depositions, answers to interrogatories and admissions of files, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c). As the Supreme Court held in *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986), the standard for ruling on a summary judgment is similar to that of a directed verdict if under governing law there can be but one reasonable conclusion. In addition the Supreme Court noted, in *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 247-48, 106 S. Ct. 2505, 2510, 91 L. Ed. 2d 202 (1986), that "the mere existence of some alleged factual dispute between the parties *will not* defeat an otherwise properly supported motion for motion for [sic] summary judgment; the requirement is that there be no genuine issue as to any material fact." *Id.* (emphasis added). Material facts have been defined as those whose resolution will be determinative of the outcome. *See also Pereira* v. *Hong Kong & Shanghai Banking Corp. (In re Kam Kuo Seafood Corp.)*, 76 B.R. 297, 300 (Bankr. S.D.N.Y. 1987).

The pleadings and accompanying documents filed in connection with the instant motions establish that no genuine dispute exists as to any material facts set forth in the parties' respective local rule 13(h) statements. Rather, summary judgement is appropriate because the parties are in agreement as to the relevant facts.

D. **Debtor's Cause of Action Based on the Fraudulent Conveyance Sections 273 and 274 of the New York Debtor and Creditor Law**

The Debtor, in its complaint, contends that the Assignment was a fraudulent conveyance pursuant to §§ 273[3] and 274[4] of the New York Debtor and Creditor Law ("DCL") and § 544 of the Code.

Pursuant to Federal Rule of Civil Procedure 12(b)(6), incorporated into bankruptcy proceedings by Bankruptcy Rule 7012(b), MARAD moves to dismiss the Debtor's cause of action based upon the fraudulent conveyance sections 273 and 274 of the DCL. The Debtor, however, does not seek summary judgment on this cause of action. Even had the Debtor included this cause of action in its summary judgment motion, this Court need not reach the merits of this issue since a determination can, and will, be made based alone on the Debtor's other causes of action set forth in the complaint. Accordingly, MARAD's motion to dismiss the Debtor's cause of action based on the fraudulent conveyance sections 273 and 274 of the DCL is dismissed.

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[3] Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without fair consideration. N.Y. Debtor and Creditor Law § 273 (McKinney 1990).

[4] Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonable small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent. N.Y. Debtor and Creditor Law § 274 (McKinney 1990).

E. **Preferential Transfer**

SA claims that the Assignment and Depository Agreement are voidable preferential transfers falling within the parameters of section 547(b) of the Code. Section 547(b) was intended to facilitate and insure the equality of distribution among the creditors of a debtor and to avoid and deter a race among the creditors to deplete the assets of the estate prior the bankruptcy filing. *Mandross* v. *Peoples Banking Company (In re Hartley)*, 825 F.2d 1067, 1069 (6th Cir. 1987). A transfer of an interest of a debtor's property is deemed to be a preference where the following five elements are satisfied:

1. It is made for the benefit of a creditor;

2. It is made for or on account of an antecedent debt owed by the debtor before such transfer was made;

3. It is made while the debtor is insolvent;

4. It is made on or within 90 days before the date of the filing of the petition; and

5. Said transfer enables the benefitted creditor to receive more than such creditor would have received had the case been a chapter 7 liquidation and the creditor had not received the transfer.

See 11 U.S.C. § 547(b).

MARAD contests the satisfaction of the third element, that the transfer was made while the Debtor was insolvent and the last element, whether MARAD received more than it would have been entitled to under a chapter 7 scenario. Additionally, MARAD argues that the preference concept does not apply in this context because the transfer did not diminish the estate to the prejudice of the creditors. Finally, MARAD asserts that, assuming arguendo

that the transfer is found to be preferential, the exceptions found in section 547(c) apply.

The other elements to a preference cause of action have undeniably been satisfied. The Assignment and Depository Agreement were transfers to or for the benefit of MARAD, a creditor, since MARAD received all rights and interests to the charter hire. (*See* Assignment Article 1.1). The Assignment and Depository Agreement were made on account of an antecedent debt, MARAD's pre-existing mortgage debt. And the Assignment and Depository Agreement were executed on November 4, 1986, within 90 days of the Petition Date.

1. Was the Debtor Insolvent at the Time of the Transfer?

Pursuant to section 547(f), a debtor enjoys the presumption of insolvency during the ninety (90) days prior to the bankruptcy filing. *See* 11 U.S.C. § 547(f). The party against whom the presumption rests, must rebut the presumption of insolvency. *Akers* v. *Koubourlis (In re Koubourlis)*, 869 F.2d 1319, 1322 (9th Cir. 1989). Section 101 of the Code defines, in pertinent part, insolvency "as a financial condition such that the sum of such entity's debt is greater than all of such entity's property, at *fair valuation*...." 11 U.S.C. § 101(31)(A) (emphasis added). In determining insolvency, the balance sheet analysis is applied: whether the debtor's assets exceed its liabilities. *In re Koubourlis*, 869 F.2d at 1321; *Jahn* v. *Fassnacht (In re A. Fassnacht & Sons, Inc.)*, 826 F.2d 458, 462 (6th Cir. 1987).

MARAD attempts to rebut the statutory presumption of insolvency by asserting that the entry for paid-in-capital in the Debtor's October and November 1986 financial statements (Plaintiff's Exhibit "J") should be excluded from the insolvency analysis because that is not a liability. Once the paid-in-capital is excluded, the Debtor's assets exceed its liabilities.

In its analysis, MARAD relies on the book value of the Debtor's assets as provided in the October and November 1986 financial statements. When determining solvency, section 101(31) provides that the value of the assets which is taken into account is the "fair value." Fair value means neither forced sale nor going concern value, rather it refers to:

> [T]he amount of money that the debtor could raise from its property in a short period of time, but not so short as to approximate a forced sale, if the debtor operated as a reasonable prudent and diligent businessman with his interests in mind, especially a proper concern for the payment of his debts.

Jahn v. *Reading Body Works, Inc. (In re A. Fassnacht & Sons, Inc.)*, 45 B.R. 209, 217 (Bankr. E.D.Tenn. 1984); *see also*, *DeRosa* v. *Buildex Inc. (In re F & S Cent. Mfg. Corp.)*, 53 B.R. 842, 849 (Bankr. E.D.N.Y. 1985) ("Fair value is determined by estimating what the debtor's assets would realize if sold in a prudent manner in current market conditions.") It stands to reason that the cost or book value is not presumptively the equivalent to fair value. *In re H & S Transp. Co.*, 110 B.R. 827 (M.D.Tenn. 1990), *aff'd* 939 F.2d 355 (6th Cir. 1991) (debtor's schedules not relied upon by the court where it was shown that the figures therein did not represent fair value.); *Excello Press, Inc.* v. *Bowers, Inc. (In re Excello Press, Inc.)*, 96 B.R. 840, 842-43 (Bankr. N.D.Ill. 1989); *accord*, *Rubin* v. *Manufacturers Hanover Trust Co.*, 661 F.2d 979, 995 (2d Cir. 1981); *In re F & S Cent. Mfg. Corp.*, 53 B.R. at 849 (balance sheet which does not indicate that debtor's assets were valued at fair value has no probative weight for determining insolvency notwithstanding the fact that it was in accordance with generally accepted accounting principals), *accord*, *Plihal* v. *First Nat. Bank (In re Plihal)*, 97 B.R. 554, 557 (Bankr. D. Neb. 1989). It is true that if the paid-in-capital figure were not included in the Debtor's October and November financial statements, the Debtor would not pass a balance sheet insolvency analysis. However, this fact does not indicate that under a fair

value approach the Debtor would not meet the insolvency criteria. Insofar as the October and November 1986 financial statements reflect the assets valued at cost they are inaccurate measures of insolvency. *Sandoz* v. *Fred Wilson Drilling Co. (In re Emerald Oil Co.)*, 695 F.2d 833, 838 (5th Cir. 1983); *Pryor* v. *Cohen (In re Blue Point Carpet, Inc.)*, 102 B.R. 311, 320 (Bankr. E.D.N.Y. 1989).

Even if MARAD has successfully rebutted the insolvency presumption, the matter could be resolved without resort to disputed material facts because of the December financial statement which presents the Debtor's assets at fair value. Straub Affidavit at ¶ 3.

"Insolvency is not always susceptible of direct proof and frequently must be determined by the proof of others factors from which the ultimate fact of insolvency on the transfer date must be inferred or presumed." *Hassan* v. *Middlesex County Nat. Bank*, 333 F.2d 838, 840 (1st Cir.), *cert. denied*, 379 U.S. 932, 85 S. Ct. 332, 13 L. Ed. 2d 344 (1964); *Bartl* v. *Twardy (In re Claxton)*, 32 B.R. 224, 232 (Bankr. E.D. Va. 1983). Where it is established that a debtor was insolvent at a date subsequent to the date of transfer, and where it is further shown that the debtor's financial condition has not changed substantially from the date of the transfer to said subsequent date, then insolvency at the prior time can be inferred from the actual and proven insolvency at the later date. *Foley* v. *Briden (In re Arrowhead Gardens, Inc.)*, 32 B.R. 296, 301 (Bankr. D. Mass. 1983), *aff'd*, *Briden* v. *Foley*, 776 F.2d 379 (1st Cir. 1985); *Seligson* v. *New York Produce Exchange*, 394 F. Supp. 125 (S.D.N.Y.1975); *Young* v. *Scandore Paper Box Corp. (In re Lucasa Int'l, Ltd.)*, 13 B.R. 596, 600 (Bankr. S.D.N.Y.1981).

The December 31, 1986 financial statement presents a more accurate picture of the Debtor's financial condition at the time of the transfer, on November 4, 1986, than either the October or November cost-based financial statements. The

December financial statement reflects a restated value of the Debtor's financial condition. As conceded by MARAD, the December financial statement shows the debtor's insolvency. MARAD Memorandum at 11. It appears that the Debtor's financial condition did not change substantially from the November 4, 1986 date of the Assignment to the date of the December financial statement. Straub Affidavit at ¶ 5. Therefore, notwithstanding MARAD's attempt to create an issue, the Debtor's insolvency can be traced back to the date of the transfer.

2. Did the Transfer Involve Property of the Estate?

A transfer is preferential only if the property or the interest in the property transferred belongs to the debtor. *Coral Petroleum Inc.* v. *Banque Paribas-London*, 797 F.2d 1351, 1355-56 (5th Cir.), *reh'g denied*, 801 F.2d 398 (5th Cir. 1986). The fundamental inquiry is whether the transfer diminished or depleted the debtor's estate. *Id.*

MARAD states that the assignment did not deplete the property of the estate because: (1) the Debtor's right to bareboat charter the Vessels was of no value to its unsecured creditors in light of MARAD's authority to consent; (2) assets over which the Debtor had no control could not be the subject of a preference because of the earmark doctrine; and (3) the Assignment merely continued, albeit in a different form, MARAD's pre-existing lien on the Debtor's possessory rights in the Vessels.

2(a) SA's Right to Charter the Vessels to Lykes Absent the Assignment

MARAD claims that the Assignment did not transfer property of the estate since the Debtor had no right to charter the Vessels without MARAD's consent and since nothing prevented MARAD from conditioning its consent to the charters and its agreement to amend Lykes' ODS Contract upon assignment of the

Charters as additional security for the mortgages. MARAD claims that the Debtor transferred to MARAD the right to enter into charter agreements as security long before the preference period. MARAD claims it would not have permitted the Debtor to charter the Vessels without the Assignment, Bowman Aff. ¶ 6, and Lykes would not have chartered the Vessels unless MARAD consented and agreed to modify the ODS Contract. List Aff. ¶ 2. MARAD concludes that absent the Assignment, the conditions precedent to the agreement to Charter could not have been satisfied. In short, MARAD views the Assignment as *sine qua non* of the Charters.

A preference involves "any transfer of an interest of the debtor in property." 11 U.S.C. § 547(b). The term "property of the estate" is expansive and "has been given an extremely broad interpretation under the Bankruptcy Act, encompassing 'anything of value which has debt-paying or debt-securing power.'" *Klein* v. *Tabatchnick*, 459 F. Supp 707, 716 (S.D.N.Y.1978). The Debtor did indeed grant to MARAD the right to consent to any bareboat chartering of the Vessels. But this was not what the Debtor transferred when it entered into the Assignment. What was transferred was the Debtor's right to receive charter hire. When the debtor granted MARAD's security interest in the Vessels, the Debtor was left only a conditional right to engage in bareboat chartering, but it did not relinquish its rights to receive any charter hire. The Debtor transferred its right to receive the charter hire when it signed within the preference period, the Assignment. *Cf. Goldstein* v. *Madison Nat. Bank*, 89 B.R. 274 (D.D.C.1988) (assignment of debtor's entitlement to certain future payments was not a preference where the assignment was absolute (as opposed to an assignment for security interest) and made outside the 90 day period, notwithstanding the fact that the future payment was to be paid within the 90 day period). To the extent that MARAD is arguing that prior to the preference period it held a perfected security interest in the charter hire, its argument is rejected by this Court later in this opinion. *See infra* at 261. Under maritime law, absent clear language to the contrary, a mortgage secured under the Ship Mortgage Act, 1920 does not extend to the freight of

vessel. *See* Ship Mortgage Act 46 U.S.C. §§ 911 et seq.; *In re Levy-Mellon Marine*, 61 B.R. 331, 334 (Bankr. W.D.La. 1986); *accord Layne & Bowler Corp.* v. *United States Shipping Bd. Emergency Fleet Corp.*, 27 F.2d 39, 41 (9th Cir. 1928); *United States* v. *Sterling*, 22 F.2d 323, 325 (S.D.N.Y.1927); *Freights of the Kate*, 63 F. 707 S.D.N.Y. 1894). None of MARAD's mortgages specifically provide that MARAD's security interest runs to freight or charter hire and therefore MARAD did not hold such an interest. However, MARAD argues that it had a security interest in the Debtor's ownership in the Vessels which is the same as a security interest in any charter hire generated. This argument fails because all that MARAD possessed was a right to block any bareboat chartering through its "veto" powers. If the Debtor were to act without MARAD's consent, MARAD would have the right to foreclose on it collateral due to an event of default by the Debtor. MARAD did not automatically and expressly have a right to the charter hire at the time its various mortgages were executed, it gained this right only though the Assignment.

Even if what was transferred in the Assignment was the Debtor's right to bareboat charter, MARAD's argument fails nevertheless. The Debtor's right to bareboat charter was essentially conditioned on MARAD's consent. MARAD's argues that the conditional nature of the Debtor's right made it valueless to the Debtor and its general creditor body and therefore a transfer of said right did not in any way deplete the assets of the Debtor's estate.

This Court finds MARAD's argument unpersuasive. The Debtor's conditional right to bareboat charter was certainly of value. A bareboat charter would indeed bring charter hire into the estate since MARAD's security interest did not extend to charter hire. The only authority cited by MARAD in support of its position is *Bergquist* v. *Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)*, 56 B.R. 339, 387-88 (Bankr. D. Minn. 1985), *aff'd in part, remanded in part*, 850 F.2d 1275 (8th Cir. 1988), where the court of appeals found certain contracts to

be worthless where they contained restrictions on assignment conditioned upon another party's consent that could be reasonably or unreasonably withheld. The *Bellanca* court made this finding in the context of an insolvency evaluation where it had to determine the value of contracts containing a restriction on assignment. The *Bellanca* decision is distinguishable because in the case *sub judice* the issue of the value of the Debtor's right to bareboat charter is not in the context of an insolvency dispute where indeed this Court would be called upon to ascribe a definite value to this right. MARAD is claiming that because the value of the Debtor's conditional right to bareboat charter was not fixed prior to the time the Assignment and Depository Agreement were executed, such right has no value.

This Court is not convinced that the Debtor's right to bareboat charter was valueless. It certainly had value, the value of the potential bareboat charters and charter hire notwithstanding MARAD's power to consent because, as discussed above, the debtor had a right to any charter hire generated. This value, while not fixed prior to the time the Assignment and Depository Agreement were entered into, could have been liquidated at any time simply by looking to the market for bareboat chartering.

Additionally, MARAD claims that without its consent there would be no charter hire and therefore there was a sort of quid pro quo transaction that did not deplete the assets of the estate to detriment of the creditors of the Debtor. However, what concerns this Court is the fact that the charter hire was not placed into the depository account for immediate payment to MARAD; instead the Debtor was free to use the funds, and did in fact use the funds until (a) it defaulted and (b) MARAD successfully enforced its Assignment. Once MARAD approved the charter, any charter hire generated did become property that was available to the Debtor's creditor body and which could be assigned away.

2(b) The Earmark Doctrine

The earmark doctrine is a judicially created exception to preference actions. The fundamental concept underlying the earmark doctrine is that in situations where the debtor never had actual control over certain funds or assets, said funds or assets never became part of the bankrupt's estate available for distribution to the creditors of the estate and accordingly, a transfer of those assets or funds would not be preferential. *Smyth* v. *Kaufman*, 114 F.2d 40, 42 (2d. Cir. 1940); *Coral Petroleum Inc.*, 797 F.2d at 1351. This doctrine is almost exclusively applied where a third party loans money to a debtor for the very specific purpose of repaying a designated debt. The funds are sometimes transferred to the creditor whose obligation is being satisfied, but the court in *Coral Petroleum Inc.* observed that the doctrine may still apply where the debtor physically receives control of the funds but the debtor lacks dispositive control over the funds. *Id.* at 1361.

MARAD states that the Debtor could not control disposition of the assets transferred to MARAD since MARAD could impose any condition upon release of that power, and, therefore the Charters created pursuant to the conditions MARAD imposed were never assets of the estate. This circular reasoning fails to fully and logically explain how the earmark doctrine applies in this case. First, MARAD is attempting to apply a doctrine which has been applied in cases with very different facts.

> In every earmarking situation there are three necessary dramatis personae. They are the 'old creditor' (the pre-existing creditor who is paid off within the 90-day period prior to bankruptcy), the 'new creditor' or 'new lender' who supplies the funds to pay off the old creditor, and the debtor.

McCuskey v. *Nat. Bank (In re Bohlen Enterprises, Ltd.)*, 859 F.2d 561, 565 (8th Cir. 1988). Here, MARAD would be the old

creditor but Lykes, the third party involved who is paying the charter hire which is to go to MARAD, is not a new creditor. Lykes is not seeking to have MARAD's debt satisfied and become a creditor of the Debtor's. To the contrary, rather than being owed money, Lykes owes money to the Debtor. Therefore, this case does not have the appropriate players in order to have an earmark situation.

Moreover, the earmark doctrine does not apply for a second and more fundamental reason: the Debtor did indeed exercise control over the charter hire. As stated above, it is because the debtor lacks control over the disposition of the funds that a court will find that the estate is not depleted in an earmark situation. Where a debtor never had access to certain funds, the funds were never available to the debtor's creditors. *In re Bohlen Enterprises, Ltd.*, 859 F.2d at 565; *Coral Petroleum Inc.* v. *Banque Paribas-London*, 797 F.2d at 1359. In this case, undeniably the Debtor had control over the charter hire from the time the charters were executed until such time when MARAD placed a hold on the depository account. The charter hire would have been removed from the Debtor's control had MARAD exercised its rights prior to the Petition Date,[y] but this is not the case. This fact alone works to preclude the application of the earmark doctrine.

2(c) The Extent of MARAD's Security Interest

Finally, MARAD argues that the Assignment did not deplete the property of the estate because the property was embraced within MARAD's security interest in the Vessels. MARAD does not attempt to argue that its security interest ran to the freight or charter hire since the mortgages did not specifically provide for that. *See*, Ship Mortgage Act 46 U.S.C. §§ 911 *et seq.*; *In re Levy-Mellon Marine*, 61 B.R. at 334; *accord Layne &*

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[y] Even if that had been the case, the issue of whether the Assignment is a preferential transfer would still exist.

Bowler Corp. v. *United States Shipping Bd. Emergency Fleet Corp.*, 27 F.2d at 41; *United States* v. *Sterling*, 22 F.2d at 325; *Freights of the Kate*, 63 F. 707 (S.D.N.Y.1894). Instead, MARAD claims that it had a secured interest in the Debtor's title in the Vessels as well as the Debtor's possession of the Vessels, as evidenced by the restriction in the Debtor's ability to charter the Vessels absent MARAD's consent. MARAD concludes that in effect what the Assignment achieved was to transfer MARAD's security interest in the Debtor's possession of the Vessels for Lykes' possession of the Vessels. MARAD seems to view the transfer as an even exchange. But this cannot be the case since the Assignment and Depository Agreement gave MARAD a security interest in the freight generated by the Vessels, a right which MARAD did not otherwise enjoy. Surely, MARAD always enjoyed the power of consent to the bareboat chartering of the Vessels, but this does not necessarily translate into a security interest in any charter hire generated by the charters approved by MARAD. A negative covenant, such as the Debtor's agreement not to bareboat charter the Vessels without MARAD's consent, is nothing more than an agreement to forebear from acting; it does not create a perfected security interest valid against a debtor in possession or trustee under the Code. *In re Continental Resources Corp.*, 43 B.R. 658, 662 (Bankr. W.D.Okl. 1984), *aff'd sub. nom. Continental Illinois Nat. Bank* v. *FDIC*, 799 F.2d 622 (10th Cir. 1986); *In re Allegheny Int'l Inc.*, 93 B.R. 907, 909-910 (Bankr. W.D.Pa. 1988); *In re Friese*, 28 B.R. 953, 954 (Bankr. D. Conn. 1983). If MARAD had wanted to secure an interest in charter hire, it should have specifically provided for that in its mortgage and security agreements. MARAD will not get at this point in time what it did not originally secure for itself.

All that MARAD received in the Debtor's negative covenant not to bareboat charter absent MARAD's consent was the right to foreclose on its collateral in the event that the Debtor defaulted, not a security interest in the Charters and/or charter hire.

3. Did MARAD Receive More Than it Would Have in a Chapter 7?

In order to satisfy the last element of a preferential transfer the Debtor must prove that the Assignment enabled MARAD to receive more than it would have if the debtor had not assigned the Lykes Charters to MARAD and if the Debtor had been liquidated on the date of transfer with MARAD receiving payment of its mortgage debt to the extent provided by the Code. 11 U.S.C. § 547(b)(5).

"Generally payments to a fully secured creditor will not be considered preferential because the creditor would not receive more in a chapter 7 liquidation.... (footnote omitted) Payments to a partially secured creditor from property not covered by its lien, however, have a preferential effect, because in a chapter 7 liquidation, that creditor would receive a distribution for its lien in addition to the payments already received." 4 *Collier on Bankruptcy* ¶ 547.08 at 547-43 (15th ed. 1990); *Braunstein* v. *Eastern Airlines Employees Federal Credit Union (In re Fitzgerald)*, 49 B.R. 62, 65 (Bankr. D. Mass. 1985). Transfers that change the status of the creditor from undersecured to fully secured are preferential where evidence indicates that no unsecured creditor would receive full payment on liquidation. *Porter* v. *Yukon Nat. Bank*, 866 F.2d 355, 359 (10th Cir. 1989).

The Debtor claims that had the Assignment not existed on the Petition Date and had the estate been liquidated on that day, MARAD would not have received the charter hire since its security interest did not encompass the charter hire. MARAD counters by stating that had the Debtor's estate been liquidated on the Petition Date, it would have received no more that it did pursuant to the Assignment because the chapter 7 trustee would have abandoned these Vessels to MARAD in the liquidation process. MARAD argues this would have been the inevitable result since the Debtor did not have equity in the Vessels (MARAD was undersecured) and the trustee would have been

compelled to turn over the Vessels or MARAD would have moved to lift the stay which would have been granted since the Debtor did not have equity in the Vessels and did not need them for an effective reorganization. Once having received possession of the Vessels, MARAD claims that it would have exercised the right to charter them itself and thereby would have received the charter hire. MARAD also points out that it did not receive actual cash from the Assignment prior to the Petition Date but rather was granted additional security interest.

When determining whether a creditor received more than it would have in a chapter 7, events that could possibly occur outside of the bankruptcy are not relevant. *See, Gosch v. Burns (In re Finn)*, 86 B.R. 902, 904 (Bankr. E.D. Mich. 1988) *rev'd on other grounds*, 909 F.2d 903 (6th Cir. 1990). What is at issue is what MARAD would have received directly from the liquidation, and not speculation as to MARAD's lost opportunity cost outside of bankruptcy had the Vessel been turned over to MARAD. What is relevant is that MARAD, an undersecured creditor, managed to enhance its security cushion through the Assignment to the extent that MARAD become entitled to the charter hire in addition to its pre-existing security interest in the Vessels. Transfers made to undersecured creditors will be deemed to be made in satisfaction of the creditor's unsecured portion. *See* 4 *Collier on Bankruptcy* ¶ 547.08 at 547-43 (15th ed. 1990). The Assignment was a preferential transfer and was MARAD's attempt to decrease its undersecured position.

F. **Exceptions to the Debtor's Avoiding Powers**

1. The New Value Exception

Section 547(c)(1) of the Code excepts from a debtor's avoiding powers transactions which are contemporaneous exchanges for new value. Section 547(c)(1) provides in pertinent part:

The trustee may not avoid, under this section, a transfer—

(1) To the extent that such transfer was—

(A) Intended by Debtor and the Creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the Debtor; and

(B) In fact a substantially contemporaneous exchange....

11 U.S.C. § 547(c)(1). New value is defined in the Code as:

> ...money or money's worth in goods, services or new credit, or release by a transferee in a transaction that is neither void nor voidable by the Debtor or the Trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation....

11 U.S.C § 547(a)(2).

MARAD, bears the burden of establishing that the Assignment and the Depository Agreement fall within an exception under section 547(c) to the Debtor's avoidance power. *See Sorenson* v. *Tire Holdings Ltd. Partnership*, 108 B.R. 752, 758 (Bankr. D.Kan. 1989); *Charisma Inv. Co., N.V.* v. *Air Florida System, Inc.*, 68 B.R. 596, 600 n. 4 (S.D. Fla. 1986), *aff'd sub nom*, 841 F.2d 1082 (11th Cir. 1988).

MARAD asserts that it provided new value for the Assignment by consenting to the Charters and by amending the Lykes' ODS contract. MARAD reasons that by consenting to the Charters, MARAD released a lien created prior to the preference period by the mortgages, the 1981 CDS Contract and the Debtor's ODS Contract. MARAD further reasons that by amending the

Lykes' ODS contract, MARAD made the Charters economically feasible, and thus indirectly provided new value in the form of the Charters themselves.

Despite MARAD's valiant attempt to keep the Assignment out of the reach of the Debtor's avoiding powers, the transaction does not come within the protections of the exceptions because MARAD did not give new value. In essence all that MARAD did not agree to forbear from proceeding with default actions against the Debtor pursuant to the terms of the various mortgages. Courts have consistently found that forbearance does not constitute "new value" under section 547(a)(2). *See American Bank of Martin County* v. *Leasing Service Corp. (In re Air Conditioning, Inc.)*, 845 F.2d 293, 298 (11th Cir. 1988), *cert. denied* 488 U.S. 993, 109 S. Ct. 557, 102 L. Ed. 2d 584 (1988); *Drabkin* v. *A.I. Credit Corp.*, 800 F.2d 1153, 1157 (D.C. Cir. 1986) (forbearance from foreclosing on collateral did not constitute new value); *Bavely* v. *Merchants Nat. Bank (In re Lario)*, 36 B.R. 582, 584 (Bankr. S.D. Ohio 1983) (court held that by agreeing to forbear the creditor was merely exercising a pre-existing right and not giving new value).

Nor did MARAD release a lien in exchange for consideration by the Debtor because, as discussed above, MARAD did not have a security interest in the charter hire prior to the preference period. *Cf. In re George Rodman Inc.*, 792 F.2d 125, 128 (10th Cir. 1986) (creditor holding a perfected materialman's lien provided new value by releasing the lien).

2. The Improvement in Position Test

MARAD also attempts to apply section 547(c)(5)[4] which

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[4] Section 547(c)(5) provides in pertinent part: the trustee may not avoid under this section a transfer—

(continued...)

codifies the "improvement in position test." MARAD claims to have held a secured interest in the Debtors's account receivable for the charter hire. This exception is aimed at a creditor holding a security interest or "floating lien" on the debtor's inventory or receivable. 4 *Collier on Bankruptcy*, ¶ 547.13 at 547-60 (15th Ed. 1990). The Code recognizes that a security interest does not attach and cannot be perfected in inventory or accounts receivable until the debtor acquires rights in them. If the secured party's position does not improve relative to what it was 90 days preceding bankruptcy, no preference has occurred. If a creditor's deficiency claim has decreased during the 90-day period *and* the decrease prejudiced other creditors holding unsecured claims, then the security interest in inventory or receivables acquired by the debtor during the 90-day period prior to bankruptcy will be a voidable preference to the extent of the decrease in the deficiency that prejudices other creditors holding unsecured claims. *Id.* at 547-60-61.

This exception does not apply in this context because MARAD did not hold a floating lien. Moreover, section 547(c)(5) presupposes that the creditor had a perfected security interest prior to the 90-day preference period. 4 *Collier on Bankruptcy* ¶ 547.13 at 547-60 (15th ed. 1990). That was not the case here. MARAD obtained and perfected a security interest vis-a-vis the Assignment. The Assignment is an agreement, separate and apart from MARAD's mortgages.

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[9](...continued)

> that creates a perfected security interest in inventory on a receivable or proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt-
>
> (A)(1)...90 days before the date of the filing of the petition....

G. **The Debtor's Assumption of the Charters**

SA assumed the Charters pursuant to the Plan. The Charters expressly provided that charter hire be paid to a financial institution designated by MARAD for credit to MARAD's account pursuant to the Assignment. MARAD concludes that since the Debtor assumed the Charters it cannot at this late date attempt to modify the Charters. MARAD's reasoning is as follows:

1. the Charters expressly provided that charter hire be paid to a financial institution designated by MARAD for credit to MARAD's account pursuant to the Assignment;

2. these charter hire provisions have never been modified;

3. by assuming the Charters, SA assumed the burden of the charter hire payment along with the benefits resulting from keeping the TBT Leases in place;

4. the relief sought in this adversary proceeding would modify the charter hire payment provisions;

5. the Debtor has no power to unilaterally modify the Charters but must adhere to all of their provisions;

6. the assumption of the Charters by the Debtor was action manifesting an intention and desire to affirm them, thereby binding the Debtor to them.

The Debtor counters by pointing out that the Charters and the Assignment are two separate agreements and, while assuming the Charters, the Debtor did not in effect assume the Assignment.

Once an executory contract is assumed, it is said to be assumed *cum onere*—with all of its benefits and burdens. *NLRB* v.

Bildisco & Bildisco, 465 U.S. 513, 531, 104 S. Ct. 1188, 1199, 79 L. Ed. 2d 482 (1984); *Hurley* v. *Atchison, T. & S.F.R. Co.*, 213 U.S. 126, 29 S. Ct. 466, 53 L. Ed. 729 (1909); *In re Steelship Corp.*, 576 F.2d 128 (8th Cir. 1978); *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3rd Cir. 1951). However, MARAD's reliance on the *cum onere* principle is misplaced. A voidable preferential transfer will not be otherwise cleansed of its preferential taint by somehow being cleverly tied into a separate valid and unavoidable transfer or agreement. If this were true, any clever creditor could be preferred, in direct violation of the Code, but be removed from the debtor's avoidance powers by tying it into a separate valid transaction. MARAD seeks to put the debtor's assuming powers and avoiding powers in direct conflict. MARAD's argument, if accepted, would mean that the Debtor could not enforce it legal right to avoid the Assignment, which has been found to be a preference, without also having to reject the Charters which generate money into the estate. This result, in these circumstances, would work a great injustice to the purpose and integrity of the Code. The result sought by MARAD flies in the face of one of the two policies which form the foundation of the Code: the equality of treatment amongst creditors.

It is true that once the Debtor assumed the Charters, it assumed its benefits along with its burdens. However, the *cum onere* principle does not provide that once assumed, every single provision of an agreement is enforceable by and against the debtor; indeed the Code itself alters certain rights of the parties. *In re Nitec Paper Corp.*, 43 B.R. 492, 498 (S.D.N.Y.1984); *In re Orgell, Inc.*, 117 B.R. 574, 575-76 (Bankr. C.D. Ca. 1990); *Rockland Center Associates* v. *TSW Stores of Nanuet (In re TSW Stores of Nanuet, Inc.)*, 34 B.R. 299, 304 (Bankr. S.D.N.Y. 1983). *See*, Beinenstock, *Bankruptcy Reorganization*, 459 (1987). MARAD had the Assignment incorporated into the Charters. The Assignment, however, does not form the basis and purpose of the Charters. The burden which MARAD deems to have been assumed by the Debtor enures only to the benefit of MARAD, a non-signatory to the Charters. Lykes' involvement and dealings

with MARAD were towards obtaining MARAD's approval of the charter of the Vessels. It is clear that Lykes had no interest in who ultimately received the charter hire. Since the Assignment and the Charters are two separate agreements, this Court will not deem the assumption of the Charters to constitute an assumption of the Assignment.

H. **The Charter Hire Stipulation**

Finally, MARAD raises the defenses of account stated, waiver, judicial, promissory and equitable estoppel. MARAD states that SA is estopped from avoiding the Assignment because in the postpetition Charter Hire Stipulation, the Debtor acknowledged that the charter hire paid by Lykes after MARAD made demand on its guarantees should be credited to MARAD.

1. **Account Stated**

MARAD claims that the Stipulation is an account stated because SA examined MARAD's claims and agreed that MARAD was entitled to the money in the depository account as of a date certain. *See*, *Bank of New York-Delaware* v. *Santarelli*, 128 Misc. 2d 1003, 1003-004, 491 N.Y.S.2d 980, 981 (1985).

2. **Waiver**

MARAD claims that by entering into the stipulation, the Debtor "intentionally and unambiguously relinquished [its] right to attack the Assignment as a preference." United States' Memorandum in Support at 50. *See*, *Hadden* v. *Consolidated Edison Co.*, 45 N.Y.2d 466, 469, 410 N.Y.S.2d 274, 275-76, 382 N.E.2d 1136, 1138-39 (1978). MARAD concedes that the Stipulation did not expressly address the preference issue, but claims that such waiver did not have to be express. MARAD infers intent not to pursue a preference action from the Debtor's

action, *i.e.*, signing the Stipulation and waiting for more than two years thereafter before it commenced this preference action.

3. **Judicial Estoppel**

Judicial estoppel applies where "a party, after assuming a particular legal position in a legal proceeding, attempts to assume a contrary position." *Galerie Des Monnaies of Geneva, Ltd.* v. *Deutsche Bank (In re Galerie Des Monnaies of Geneva, Ltd.)*, 55 B.R. 253, 259 (Bankr. S.D.N.Y.1985), *aff'd* 62 B.R. 224 (S.D.N.Y.1986). MARAD claims that the Debtor should be estopped from pursuing this preference action because it made a representation in the Disclosure Statement that the Debtor believed that no voidable preferences had occurred, a position consistent with the Stipulation. MARAD posits that the Debtor had to have known of the possible preference action and deceived MARAD into a false sense of security.

4. **Promissory and Equitable Estoppel**

MARAD claims that SA's failure to challenge the Assignment as a preference until the Charters had nearly expired and almost three years' worth of charter hire had accumulated in the depository account deprived MARAD of the opportunity to pursue available alternatives if it had reason to think that its agreement with the Debtor might be set aside. Specifically, MARAD claims that it did not seek relief from the stay to assert its rights as mortgagee of the Vessels in light of the fact that Chemical's objection to the Stipulation was the only obstacle preventing MARAD from receiving the charter hire and that MARAD and Chemical were working towards a resolution of Chemical's objection. MARAD speculates that upon obtaining relief from the stay, it would have chartered the

Vessels to Lykes in order to maximize recovery of its mortgage debt.

Equitable Estoppel under New York law entails:

i. Conduct which amounts to false representations or concealment of material facts which gives the impression that the facts are otherwise than asserted;

ii. An intention or expectation that such conduct would be relied upon by the other party; and

iii. Actual or constructive knowledge of real facts. *Eastern Sys.* v. *West 45th St. Ind. Condominiums, Inc.*, 105 B.R. 219, 234 (Bankr. S.D.N.Y.1989). The party asserting equitable estoppel must show: a lack of knowledge of the real facts; reliance on the conduct of the party to be estopped; and prejudicial change of position. *Id.*

The doctrine of promissory estoppel is similar but requires the allegation of a promise rather than inequitable conduct. *Id.* at 234 n. 4.

This Court denies MARAD's appeal to equity. This Court will not bind the Debtor to the Stipulation because the Stipulation has not been court approved. Although the Stipulation was presented to Judge Buschman for his approval, it seems that its merits were not considered by the court in light of Chemical's objections. The Debtor has always enjoyed the right to withdraw its participation in the Stipulation since it has not been recognized by a court. The account stated theory is not applicable because the issue is not the amount of indebtedness owed to a creditor but rather whether the transfer was preferential. Waiver does not apply because this Court will not infer from the Debtor's silence that it

knowingly and affirmatively waived its right to commence this adversary proceeding.

The different estoppel theories espoused by MARAD do not convince this Court to hold in favor of MARAD because the Debtor's actions do not rise to the level necessary to warrant such equitable relief. MARAD claims that it was somehow misled by the Debtor's Disclosure Statement because the Debtor failed to make mention of a possible preference action against MARAD. The Debtor's Disclosure Statement stated:

> Except as specifically described in the Disclosure Statement, the Debtors are not aware of any claims for avoidance or recovery of property assertable under the Bankruptcy Code which would materially affect Distributions to Creditors and Interest Holders under the Plan, however, the Debtors have reserved the right to assert any such claims should the Debtor become aware of their existence. Any such claims shall become the property of Reorganized MII or the USL Reorganization Trust, as the case may be.

Disclosure Statement at 13. In support of its position, MARAD cites to *In re Galerie Des Monnaies of Geneva, Ltd.*, 55 B.R. 253 (Bankr. S.D.N.Y.1985), wherein Judge Buschman denied a debtor's preference action based on judicial estoppel. In *In re Galerie* the Debtor represented to the court in its Disclosure Statement that pursuant to discussions with its counsel and accountants, it believed that there did not exist any preferences and fraudulent actions. The court in *In re Galerie*, found that at the time of the hearing on the adequacy of the disclosure statement, the debtor knew but did not disclose to the court the existence of the preferential transfer which it intended to avoid. Unlike in *In re Galerie*, the undisputed facts before this Court do not show that the Debtor filed its Disclosure Statement knowing that the Assignment to MARAD was a possible preferential transfer and that it intended to avoid said transfer. Moreover, in the Disclosure

Statement the Debtor did in fact specifically reserve the right to pursue preferential transfers that came to its attention. There has not been any concealment by the Debtor in this case. What has occurred is that prior to commencing the action to avoid the Assignment, the Debtor was not aware that it had before it a possible preference cause of action. The possibility of a preference cause of action is not addressed in the Stipulation. MARAD did not seek protection by requesting that the Debtor agree to not commence a preference action pending court approval of the Stipulation. When MARAD entered into the Stipulation and decided to rely on it and not take any further actions in the case, MARAD took a calculated risk that the Debtor would, prior to court approval of the Stipulation, become aware of the possible preferential nature of the Agreement and take appropriate action. MARAD was not an innocent party duped by the Debtor into foregoing any of its rights. In fact, if MARAD was truly not aware of the possible preference action, then neither party was mislead because neither purposely concealed anything from the other. This Debtor has not committed the kind of egregious and dishonest acts of which the debtor in *In re Galerie* was guilty.

Conclusion

In accord with this opinion, the Debtor's motion for summary judgement is granted and MARAD's motion for summary judgement is denied.

The Debtor is directed to settle an Order on five (5) days' notice consistent with this opinion.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re McLEAN INDUSTRIES, INC., et al., *Debtors*,	:	Chapter 11 Case Nos. 86-B-12238 through 86-B-12241 (CB)
UNITED STATES LINES (S.A.), INC., *Plaintiff-Appellee*, -against- UNITED STATES OF AMERICA, and CHEMICAL BANK, in its capacity as depository, *Defendants*.	:	Adv. Pro. No. 89-6125A

ORDER GRANTING DEBTOR'S MOTION FOR SUMMARY JUDGMENT AND DENYING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

WHEREAS, United States Lines (S.A.), Inc. (the "Debtor") commenced this adversary proceeding against The United States of America (the "Defendant"), on behalf of the Maritime Administration ("MARAD"), to avoid as a preference under section 547(b) of the Bankruptcy Code, 11 U.S.C. § 547(b), the assignment pursuant to that certain Charter Assignment and

Agreement among the Debtor, MARAD, and Lykes Bros. Steamship Company ("Lykes") dated November 4, 1986 (the "Assignment") to MARAD of (1) the three bareboat charters between the Debtor and Lykes dated November 4, 1986 (the "Charters") and (2) the charter hire and other amounts payable to the Debtor by Lykes under the Charters (the "Charter Hire"), which Charter Hire was payable to Chemical Bank ("Chemical") for credit to a special depository account (the "Depository Account" or "Account") pursuant to the Charters, the Assignment, and that certain Depository Agreement between MARAD and Chemical dated November 4, 1986 (the "Depository Agreement") (the Charters, the Assignment, and the Depository Agreement are hereinafter collectively referred to as the "Agreements");

WHEREAS, under the Debtor's First Amended and Restated Joint Plan of Reorganization, confirmed by this Court on May 16, 1989, the United States Lines/United States Lines (S.A.) Reorganization Trust (the "USL/USL(SA) Reorganization Trust") became the successor in interest to the Debtor in respect of this adversary proceeding;

WHEREAS, the Debtor received certain Charter Hire proceeds paid by Lykes to Chemical pursuant to the Agreements prior to (1) having received a notice of default from MARAD and (2) MARAD's notice to Chemical pursuant to the Depository Agreement of a demand upon MARAD's Title XI guarantees and MARAD's instructions to Chemical to hold for MARAD's account all Charter Hire deposited by Lykes in the Account;

WHEREAS, the Charter Hire and the proceeds thereof have been deposited from time to time in the Depository Account, and interest has been earned thereon and credited to the Account;

WHEREAS, the Debtor moved for summary judgment in this adversary proceeding, the Defendant brought a cross-motion for summary judgment, the parties submitted briefs, and this Court heard oral argument and rendered its Decision on Motion and

Cross-Motion for Summary Judgment Pertaining to an Alleged Preferential Transfer on September 11, 1991 (the "Decision");

WHEREAS, the Court issued its Errata/Addendum on the Decision, incorporated in the Decision, on September 17, 1991;

WHEREAS, pursuant to the Decision, this Court directed the Debtor to settle an order consistent with the Decision on five (5) days' notice to the parties to this adversary proceeding;

THEREFORE, IT IS HEREBY ORDERED:

1. The Debtor's motion for summary judgment is granted and the Defendant's motion for summary judgment is denied. For the reasons set forth in the Decision, the Assignment to MARAD pursuant to the Agreements was a preferential transfer under section 547(b) of the Bankruptcy Code, 11 U.S.C. § 547(b). For the reasons set forth in the Decision, the Defendant, on behalf of MARAD, has no defenses to avoidance of such preference transfer, and the Assignment is hereby avoided pursuant to section 547(b) of the Bankruptcy Code, 11 U.S.C. § 547(b).

2. Pursuant to section 551 of the Bankruptcy Code, 11 U.S.C. § 551, the Assignment pursuant to the Agreements is preserved for the benefit of the Debtor's estate.

3. Under section 550 of the Bankruptcy Code, 11 U.S.C. § 550, the USL/USL(SA) Reorganization Trust may recover, for the benefit of the Debtor's estate, all sums transferred to MARAD and/or Chemical, as depository, pursuant to the Agreements, including all Charter Hire proceeds and interest thereon in the Depository Account. The Defendant, MARAD, and Chemical, as depository, are directed to take such actions as necessary to turn over all amounts in the Depository Account, including all principal and interest therein with respect to the Charter Hire, immediately to the USL/USL(SA) Reorganization Trust. Within ten (10) days from the date hereof, the Defendant and MARAD are directed to

identify any other amounts, if any, constituting Charter Hire or the other proceeds thereof, and interest thereon, and to immediately turn over such amounts, or the value thereof, to the USL/USL(SA) Reorganization Trust.

4. Under section 502(d) of the Bankruptcy Code, 11 U.S.C. § 502(d), unless the Defendant and MARAD take such actions as necessary to turn over all amounts in the Depository Account and any other amounts constituting Charter Hire, the proceeds thereof and interest thereon to the USL/USL(SA) Reorganization Trust as provided herein, their claims in the Debtor's chapter 11 case will be disallowed.

Dated: New York, New York
October 4, 1991

/s/ Cornelius Blackshear
UNITED STATES BANKRUPTCY JUDGE

Supreme Court, U.S.
FILED
JAN 3 1995
OFFICE OF THE CLERK

No. 94-798

In the Supreme Court of the United States

OCTOBER TERM, 1994

UNITED STATES LINES REORGANIZATION TRUST, SUCCESSOR TO UNITED STATES LINES (S.A.), INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Before it was amended in 1984, Section 546(a) of the Bankruptcy Code provided that an action to avoid a preference could not be commenced "after the earlier of—(1) two years after the appointment of a trustee under [certain sections of the Bankruptcy Code] * * * or (2) the time the case is closed or dismissed." 11 U.S.C. 546(a). The question presented is whether the two-year limitation period in subsection (a)(1) of former Section 546 applied to a preference-avoidance action brought by a debtor in possession.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. App. A1-A8) is reported at 30 F.3d 385. The opinion of the district court (Pet. App. A13-A43) is reported at 162 B.R. 410. The opinion of the bankruptcy court (Pet. App. A46-A84) is reported at 132 B.R. 247.

JURISDICTION

The judgment of the court of appeals was entered on July 28, 1994. Pet. App. A9-A10. The petition for a writ of certiorari was filed on October 25, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISION INVOLVED

Before its amendment in 1994, Section 546(a) of the Bankruptcy Code, 11 U.S.C. 546(a), provided in relevant part:

> An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of —
>
> (1) two years after the appointment of a trustee under [certain sections of the Bankruptcy Code] * * * or
>
> (2) the time the case is closed or dismissed.[1]

STATEMENT

1. Petitioner, United States Lines Reorganization Trust, is the successor under a confirmed bankruptcy reorganization plan to United States Lines (S.A.), Inc., a

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[1] Section 546(a) was amended effective October 22, 1994, by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 216, 108 Stat. 4126-4127. As amended, Section 546(a) provides in relevant part:

> An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of —
>
> (1) the later of —
>
> (A) 2 years after the entry of the order for relief; or
>
> (B) 1 year after the appointment or election of the first trustee under [certain sections of the Bankruptcy Code] * * * if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
>
> (2) the time the case is closed or dismissed.

The parties agree that the present case is governed by the prior version of Section 546(a). See Pet. 11 & n.11.

shipping company (both of which will hereafter be referred to as "USL"). USL owned three ships on which the federal Maritime Administration (MARAD) held an undersecured mortgage. In 1986, another shipping company, Lykes Brothers Steamship Company (Lykes), offered to charter the three ships from USL. The charters were made subject to the approval of MARAD. MARAD agreed to approve the charters provided that USL assign the payments (the "charter hire") that Lykes was to make under the charters to MARAD. USL agreed to do so. Pet. App. A3, A16-A17, A49-A50.

The arrangements among USL, Lykes, and MARAD were formalized in a series of written agreements signed on November 4, 1986. Under the agreements, Lykes would pay the charter hire to an intermediary, Chemical Bank. Chemical Bank would forward the charter hire to USL as long as MARAD received no demand on its mortgage guarantees. If MARAD received such a demand, however, Chemical was, upon receiving notice of the demand, to stop forwarding the charter hire to USL pending instructions from MARAD. It is this assignment agreement between USL and MARAD that USL sought to avoid in this action. Pet. App. A3-A4, A17, A50-A52.

On November 24, 1986, USL filed a petition in the United States Bankruptcy Court for the Southern District of New York, seeking relief under Chapter 11 of the Bankruptcy Code. USL continued operating as a debtor in possession. In early 1987, MARAD received a demand on its mortgage guarantees and notified Chemical Bank to hold all further charter hire paid by Lykes. Chemical Bank did so, in accordance with the assignment agreement of November 4, 1986. At the end of the first year of the charters, MARAD agreed to an

extension of the charters and related agreements for two more years. Pet. App. A4, A17-A18, A52-A53.

In May, 1989, the bankruptcy court confirmed USL's plan of reorganization. Under the plan, USL assumed the charters. The plan did not address the status of the assignment agreement. Pet. App. A4, A19, A55.

2. Two years and ten months after USL filed for bankruptcy, USL brought this action to avoid the assignment agreement under 11 U.S.C. 547(b). Pet. App. A4. MARAD responded, among other things, that the action was untimely. USL replied that the action was timely under former 11 U.S.C. 546(a) (see page 2 and note 1, *supra*), as construed in *In re Korvettes, Inc.*, 67 B.R. 730 (S.D.N.Y. 1986). See Pet. App. A5. At that time, Section 546(a) stated that a preference-avoidance action could not be brought after the earlier of "(1) two years after the appointment of a trustee" or "(2) the time the case is closed or dismissed." 11 U.S.C. 546(a). In *Korvettes*, the district court held that the two-year limitation period in subsection (a)(1) of former Section 546 did not apply to a preference-avoidance action by a debtor in possession, because in such a case a trustee has never been appointed. 67 B.R. at 733-734; see Pet. App. A5.

The bankruptcy court granted summary judgment for USL, Pet. App. A46-A84, A85-A88, relying on *Korvettes* to reject MARAD's timeliness objection, *id.* at A59. The district court affirmed. *Id.* at A13-A43.[2]

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[2] The district court also affirmed the bankruptcy court's holdings that MARAD had waived sovereign immunity from this action and that the assignment agreement was avoidable under 11 U.S.C. 547(b). Pet. App. A21-A42. The court of appeals did not address those holdings, *id.* at A7, and they are therefore not at issue in this Court.

3. The United States Court of Appeals for the Second Circuit reversed, holding that this action is time-barred. Pet. App. A1-A8. The court observed that in *In re Century Brass Prods., Inc.*, 22 F.3d 37 (1994), it had "held for the first time * * * that the 'appointment of a trustee' in § 546(a)(1) was equivalent to the filing of a petition in debtor-in-possession cases" and thus had "overruled *Korvettes*." Pet. App. A5. On the authority of *Century Brass*," the court held in this case that USL's action was untimely because it was commenced more than two years after the filing of the bankruptcy petition. *Id.* at A7.[3]

ARGUMENT

1. Petitioner asks this Court to grant certiorari to decide whether former Section 546(a)(1) applied to preference-avoidance actions brought by debtors in possession. Pet. 9-25. This Court recently declined further review of that issue in *Maurice Sporting Goods, Inc.* v. *Maxway Corp.*, cert. denied, No. 94-632 (Nov. 28, 1994), and it should do so here. The issue is of no continuing importance in light of Congress's 1994 amendment of Section 546(a).

Before Section 546(a) was amended in 1994, the courts of appeals differed with regard to the question presented here. The Fourth Circuit had held that former Section 546(a)(1) did not apply to preference-avoidance actions brought by debtors in possession. Every other circuit to

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[3] USL argued in the court of appeals that, "even if *Century Brass* applies," 11 U.S.C. 502(d) "still prevents MARAD from reaping the alleged benefit of the assignment." Pet. App. A7. The court determined that the Section 502(d) issue had not been adequately briefed and might require further factual development. *Id.* at A8. It accordingly remanded the case to the bankruptcy court for consideration of that issue. *Ibid.*

consider the issue, however, had reached a contrary conclusion.[4]

Congress resolved the disagreement in the lower courts by amending Section 546(a) in the Bankruptcy Reform Act of 1994 (1994 Reform Act), Pub. L. No. 103-394, 108 Stat. 4106. Section 546(a)(1) now provides that preference-avoidance actions are timely if brought before the later of "(A) 2 years after the entry of the order for relief" or "(B) 1 year after the appointment or election of the first trustee * * * if such appointment or such election occurs before the expiration of" the original two-year period. 1994 Reform Act § 216, 108 Stat. 4126-4127. As amended, Section 546(a)(1) sets an absolute time limit for a preference-avoidance action that applies regardless whether the action is brought by a debtor in possession or a trustee. Thus, the issue of interpretation that arose under former Section 546(a)(1) will not arise in preference-avoidance actions brought in bankruptcy cases commenced after the effective date of the amendment, October 22, 1994. 1994 Reform Act § 702(b)(1), 108 Stat. 4150.

Despite the amendment, petitioner claims that review by this Court is warranted because of the large number of bankruptcy cases pending on the effective date of the amendment. Pet. 12. Review is not warranted on that ground, however, since it is unlikely that any more than

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[4] Compare *In re Century Brass Prods., Inc.*, 22 F.3d 37, 40 (2d Cir. 1994) (former Section 546(a)(1) applied to debtors in possession); *In re Coastal Group Inc.*, 13 F.3d 81, 84 (3d Cir. 1994) (same); *In re Softwaire Centre Int'l, Inc.*, 994 F.2d 682, 684 (9th Cir. 1993) (same), and *Zilkha Energy Co.* v. *Leighton*, 920 F.2d 1520, 1524 (10th Cir. 1990) (same) with *In re Maxway Corp.*, 27 F.3d 980, 985 (4th Cir. 1994) (former Section 546(a)(1) did not apply to debtors in possession), cert. denied, No. 94-632 (Nov. 28, 1994).

a tiny fraction of pending cases will give rise to preference-avoidance actions by debtors in possession the timeliness of which depends on resolution of the question presented here.

2. In any event, the court of appeals in this case correctly held that former Section 546(a)(1) of the Bankruptcy Code applies to preference-avoidance actions brought by debtors in possession. Pet. App. A7. That holding comports with the language and purpose of the Code.

As relevant here, former Section 546(a)(1) provided that an action to avoid a preference under Section 547(b) had to be brought within two years after appointment of a trustee. Section 547(b) in turn authorizes trustees to avoid certain pre-petition transfers. Section 547 does not, however, expressly authorize a debtor in possession to bring a preference-avoidance action. That authority is found instead in Section 1107(a). Section 1107(a) subjects a debtor in possession to "any limitations" that the Code imposes on a Chapter 11 trustee. 11 U.S.C. 1107(a); see also S. Rep. No. 989, 95th Cong., 2d Sess. 116 (1978) (Section 1107 "places a debtor in possession in the shoes of a trustee in every way"). The Second Circuit has correctly held that the two-year limitation period in former Section 546(a)(1) is one of the "limitations" to which debtors in possession are subject, and that the limitation is triggered by the filing of a bankruptcy petition, because that event is analogous to the appointment of a Chapter 11 trustee. *In re Century Brass Prods., Inc.*, 22 F.3d 37, 40 (1994).

The Second Circuit's interpretation accords with the purpose of the Code to treat Chapter 11 trustees and debtors in possession alike. "[T]here would be no reason to create a different limitation period for the filing of actions by the two fiduciaries." *Zilkha Energy Co.* v.

Leighton, 920 F.2d at 1524. Applying the former two-year limitation period to a debtor in possession "complement[ed] the [debtor in possession's] duty to negotiate in good faith with the individual creditors against whom the [debtor in possession] may have preference or avoidance claims and to disclose early on to its creditors the potential for recovery of assets for the estate." *In re Coastal Group Inc.*, 13 F.3d at 85.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JANUARY 1995